

# Moral Hazard, Bank Supervision and Risk-Based Capital Requirements

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## I. INTRODUCTION

The problem of moral hazard in banking is hardly new. Ever since the strengthening of lender-of-last-resort support for banking system stability, along with government deposit insurance for banks, the public has grown increasingly confident that most banks should not be allowed to fail.<sup>1</sup> The evolution of modern macroeconomic policy (from Marriner Eccles and early Keynesian pump priming, through mild post-World War II Neo-Keynesian deficit stimulus, and into supply-side deficits during the 1980s) further strengthened a general belief that governments cannot afford to let their banking systems and most major banks fail.<sup>2</sup> Inevitably, bank managers could place growing reliance on this network of support for overall economic prosperity and their own institution's relative security. In this way, however, the normal marketplace disciplines against inadequate management—what many refer to as “moral hazard”—could be significantly weakened. If governments and modern nations do not allow most banks to default on their deposit liabilities, how can the leaders and managements of banking institutions be disciplined and avoid unduly risky, negligent, or adventurous lending policies (or simply poor asset-liability management)?<sup>3</sup>

During the later 1970s to the early 1980s, some giant bank leaders began to suggest that the largest banks were so big, so well-staffed, and so broadly diversified

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1. See, e.g., C. GOLEMBE & D. HOLLAND, *FEDERAL REGULATION OF BANKING* 1986–87, at 109–28 (1986); C. HENNING, W. PIGOT & R. SCOTT, *FINANCIAL MARKETS AND THE ECONOMY* 90–106 (4th ed. 1984) [hereinafter C. HENNING]; D. KIDWELL & R. PETERSON, *FINANCIAL INSTITUTIONS, MARKETS, AND MONEY* 215–18, 415–20 (3d ed. 1988); N. LASH, *BANKING LAWS AND REGULATIONS* 22–23 (1987); W. LOVETT, *BANKING AND FINANCIAL INSTITUTIONS LAW* 122–28 (2d ed. 1988) [hereinafter W. LOVETT, *BANKING*]; M. MALLOY, 1 *THE CORPORATE LAW OF BANKS* § 1.3.3 (1988 & Supp. 1988); T. MAYER, J. DUESENBERY & R. ALIBER, *MONEY, BANKING, AND THE ECONOMY* 22–24 (3d ed. 1987) [hereinafter T. MAYER]. For summaries of applicable U.S. economic history, see generally J. GALBRAITH, *MONEY* 134–282 (1975); S. HYMAN, *MARRINER S. ECCLES* (1976); M. MYERS, *A FINANCIAL HISTORY OF THE U.S.* 287–314 (1970); P. STUDENSKI & H. KROOS, *FINANCIAL HISTORY OF THE UNITED STATES* 302–568 (2d ed. 1963). For further information on bank risks, failures, and regulatory strategies, see generally G. BENSTON, R. EISENBEIS, P. HORVITZ, E. KANE & G. KAUFMAN, *PERSPECTIVES ON SAFE AND SOUND BANKING* 28–33 (1986) [hereinafter G. BENSTON]; R. DALE, *THE REGULATION OF INTERNATIONAL BANKING* (1984); I. SPRAGUE, *BAILOUT* 242–48 (1986); J. WELCH, *THE REGULATION OF BANKS IN THE MEMBER STATES OF THE EEC* (2d ed. 1981); *UK BANKING SUPERVISION* (E. Gardener ed. 1986).

2. See, e.g., G. BENSTON, *supra* note 1, at 28–33; R. DALE, *supra* note 1, at 53–87; J. GALBRAITH, *supra* note 1, at 134–282; D. KIDWELL & R. PETERSON, *supra* note 1, at 535–56; W. LOVETT, *BANKING*, *supra* note 1, at 55–56, 122–28; T. MAYER, *supra* note 1, at 374–99; I. SPRAGUE, *supra* note 1, at 242–48; P. STUDENSKI & H. KROOS, *supra* note 1, at 403–568. See also C. GOLEMBE & D. HOLLAND, *supra* note 1, at 109–28; C. HENNING, *supra* note 1, at 542–53; N. LASH, *supra* note 1, at 9–17; M. MYERS, *supra* note 1, at 378–91; A *General Perspective of Banking Prudential Regulation*, in *UK BANKING REGULATION* 25 (E. Gardener ed. 1986) [hereinafter *General Perspective*]; see generally S. HYMAN, *supra* note 1; J. WELCH, *supra* note 1.

3. For helpful discussion of the moral hazard regulation dilemma, see, e.g., G. BENSTON, *supra* note 1, at 246–48; D. KIDWELL & R. PETERSON, *supra* note 1, at 410–18; N. LASH, *supra* note 1, at 102–25; W. LOVETT, *BANKING*, *supra* note 1, at 118–28; T. MAYER, *supra* note 1, at 35–39; I. SPRAGUE, *supra* note 1, at 18–19, 231–65.

that they could not possibly fail.<sup>4</sup> Further, they asserted that "governments could never default" on their loans to big international banks, so that a growing bonanza of international deposits (from spreading MNE (multinational enterprise) activities, tax-havens, and petro-dollars) was immune to problems of credit risk in the hands of giant multinational banks. Such hubris deserved a comeuppance, of course, and it was repaid rather generously. It became obvious in the fall of 1982 that most of the biggest U.S. banks (and some leading foreign banks) were badly over-exposed to Latin American and other developing country debt overloads. In fact, if these developing countries all defaulted together on their external obligations, most of the top ten U.S. banks would be insolvent (because their outstanding LDC (less developed country) loans substantially exceeded equity capital).<sup>5</sup> Although federal bank regulators had allowed Penn Square Bank (\$200 million in assets) to fail in the summer of 1982 without protecting uninsured depositors, as a lesson and warning to "higher flying" banks and big depositors, Continental Illinois Bank (\$42 billion in assets and 7th largest in the nation) proved "too big to fail" in 1983.<sup>6</sup> Continental Illinois received a \$4.5 billion FDIC (Federal Deposit Insurance Corporation) bailout, and the government guaranteed all depositors (regardless of size). The Federal Reserve, FDIC, and OCC (Office of the Comptroller of the Currency) quite properly decided that no major U.S. money center bank could be allowed to fail and inflict massive losses upon foreign and domestic depositors. The integrity of the U.S.

4. For the most complete analyses and listings of bank failures, see G. BENSTON, *supra* note 1, at 1-78; W. LOVETT, *BANKING*, *supra* note 1, at 122-28; I. SPRAGUE, *supra* note 1, at 265-70. For discussion of the optimism and overconfidence of large multinational banks at the peak of the international banking boom, see, e.g., S. DAVIS, *THE EURO-BANK* 136-49 (2d ed. 1980); M. MENDELSON, *MONEY ON THE MOVE* 122-35 (1980); Lovett, *Managing the World Debt Crisis: Economic Strains and Alternative Solutions*, 21 *STAN. J. INT'L LAW* 499, 499-507 (1985) and sources cited therein. The post-LDC debt overload crisis assessment is more realistic and emphasizes previous overconfidence. See, e.g., B. COHEN, *IN WHOSE INTEREST?* 18-55, 204-35 (1986); R. DALE, *supra* note 1, at 75-87; D. DELAMAIDE, *DEBT SHOCK* 232-51 (1984); Y. PARK & J. ZWICK, *INTERNATIONAL BANKING IN THEORY AND PRACTICE* 109-38 (1985).

5. The default insolvency potential of major U.S. multinational banks was quickly appreciated during the fall of 1982. See D. DELAMAIDE, *supra* note 4, at 232-34; J. MAKIN, *THE GLOBAL DEBT CRISIS* 217-23 (1984). By the fall of 1988, the LDC debt overload problems of leading U.S. multinational banks had eased some, but were still serious. See, e.g., *Big Banks Shift From Third World*, *N.Y. Times*, July 27, 1988, at D-1, col. 3. As of June 30, 1988, the outstanding LDC loan portfolios of major U.S. banks were:

	<u>LDC Loans</u>	<u>As % of Equity</u>
Citicorp	\$9.5b.	N.A.
Bank of America	7.1b.	200
Manufacturers Hanover	7.1b.	244
Chase Manhattan	6.4b.	148
Chemical Banking	4.5b.	143
J.P. Morgan	3.6b.	70
Bankers Trust	3.0b.	94
First Chicago	1.4b.	71
Wells Fargo	0.9b.	36
First Interstate	0.8b.	33
Security Pacific	0.8b.	21
	<u>\$45.0b.</u>	<u>101 (13 bank composite)*</u>

\* (Includes Bank of Boston and Republic New York with only \$0.4b. and \$0.3b. respectively, of LDC loans). *Id.* (statistics from Salomon Brothers).

6. For a good summary of recent major bank failures and bailouts, see I. SPRAGUE, *supra* note 1, at 109-228.

capital market and the competitiveness of U.S. multinational banks in the world market required full protection for depositors and large banks. A similar \$4 billion FDIC bailout was extended in July 1988 to First Republic Bank, the largest Texas bank, with \$27 billion in assets.<sup>7</sup> While a great many smaller banks have been allowed to fail in the 1980s, with widespread distress in agricultural and oil-patch banking and thrift failures, most larger deposits *in fact* have been fully protected.<sup>8</sup> Certainly a double standard seems evident in Reagan-era bank regulatory policy, which arguably encourages larger depositors to switch funding into bigger banks that are considered too big to fail. This policy deserves more concern and criticism. But the overall need to prevent most of the banking system from collapse, disruption, or failure still is widely accepted by Congress and the public. In fact, no presidential administration would be re-elected if extensive or large scale failures of banks or financial institutions were allowed to jeopardize the country's liquidity or international credit-worthiness. This political imperative underlies the need for continued bank supervision and adequate capitalization for financial institutions.<sup>9</sup>

Although some deregulation enthusiasts urged that bank supervision and capitalization be relaxed substantially in the early 1980s—or even that government deposit insurance be eliminated—this mood is passing.<sup>10</sup> As Reagan-era bank

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7. See Schwartz, Gibney & Thomas, *Marrying for Money*, NEWSWEEK, Aug. 8, 1988, at 48; Hayes, *Talking Deals—FDIC's Savy on Bank's Taxes*, N.Y. Times, Aug. 4, 1988, at D-2, col. 1.

8. See W. LOVETT, BANKING, *supra* note 1, at 55–56, 122–28; I. SPRAGUE, *supra* note 1, at 242–64; see generally *Congress Will Provide Full Faith and Credit Backing for FSLIC Notes, FHLBB's Wall Says*, [July–Dec.] Banking Rep. (BNA) No. 51, at 307 (Aug. 22, 1988) [hereinafter *Congress Will Provide*]; *FDIC Has Become Insurer of the Banking System, Not Just Deposits, Seidman Says*, [July–Dec.] Banking Rep. (BNA) No. 51, at 252 (Aug. 15, 1988) [hereinafter *FDIC Has Become*]; *Financial Condition of Commercial Banks Steadily Declines Since 1981, GAO Says*, [July–Dec.] Banking Rep. (BNA) No. 51, at 168 (Aug. 1, 1988) [hereinafter *Financial Condition*]; *Senate Adopts Resolution Pledging Full Faith and Credit for FSLIC Notes*, [July–Dec.] Banking Rep. (BNA) No. 51, at 204 (Aug. 8, 1988) [hereinafter *Senate Adopts Resolution*]; Bock, Hornik & Svoboda, *Bleak Year for the Banks*, TIME, Dec. 28, 1987, at 60; Caliguire & Thomson, *FDIC Policies for Dealing with Failed and Troubled Institutions*, ECON. COMMENTARY (Fed. Reserve Bank of Cleveland), Oct. 1, 1987, at 1; Gorman, Hornik & Woodbury, *Cracks in the System*, TIME, Aug. 29, 1988, at 54; Brumbaugh & Litan, *The Banks are in Big Trouble, Too*, N.Y. Times, Aug. 21, 1988, § 3, at 3, col. 1.

9. See W. LOVETT, BANKING, *supra* note 1, at 55–56, 122–28; I. SPRAGUE, *supra* note 1, at 242–64; see also *Congress Will Provide*, *supra* note 8, at 307; *FDIC Has Become*, *supra* note 8, at 252; *Senate Adopts Resolution*, *supra* note 8, at 204; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; Gorman, Hornik & Woodbury, *supra* note 8, at 54; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1. Caliguire and Thomson concluded that: "The trend in bank failure resolution policies has reached a point of 100 percent de facto insurance for all depositors and most creditors, and at least some protection for stockholders." Caliguire & Thomson, *supra* note 8, at 6. But many commentators would agree with Sprague that this absolute, and perhaps excessive protection with respect to shareholders, applied only to the large banks. I. SPRAGUE, *supra* note 1, at 242–43, 259. Uninsured depositors (those whose deposits exceed \$100,000) could occasionally take losses in smaller banks, thus encouraging the placement of bigger deposits in larger banks that are considered too big to fail. These differences in treatment for different sized banks left most experts with uncomfortable feelings. See, e.g., G. BENSTON, *supra* note 1, at 89–90. Sprague's solution would be to equalize the burdens and risk with virtually 100% deposit insurance (by FDIC assessments on all deposits, foreign and domestic), and place the primary costs of failure upon stockholders and management. I. SPRAGUE, *supra* note 1, at 262–64. For a discussion of systemic failure risks, see *infra* notes 45–56 and accompanying text.

10. For some banking and financial scholars, the idea of increasing market opportunities and pricing discipline always appealed, but most of them understood the modern political and macroeconomic constraints and realities. First, the public and politicians expect safe, sound banking with virtually 100% deposit insurance. Second, the public, politicians, most economists, and the business establishment want a safe, sound liquidity and payments system with no significant risks of financial panic, widespread bank failures, or another Great Depression. This leaves only limited room to maneuver for: (i) increased latitude for bank growth, diversification, and competition; (ii) more interest rate freedom; (iii) stronger supervision to limit undue risk taking; or (iv) more market discipline in deposit insurance or risk-based capital requirements. A few took extreme positions on deregulation, e.g., eliminate the FDIC and trust financial markets

regulators became more experienced at this work, the third-world debt overload crisis grew more serious, and more U.S. banks and thrifts became troubled institutions, the need for continuing supervision and adequate capital was better appreciated and far more widely understood.

Between 1983 and 1987, federal bank regulators gradually strengthened capital requirements quite substantially, and in 1987 and 1988, the G-12 countries established common guidelines for risk-based bank capital requirements.<sup>11</sup> This Basle

to allow banks to operate freely again, with some Federal Reserve supervision and lender-of-last-resort support. But most experts agreed that such drastic change was impractical politically and probably undesirable economically.

What emerged in the 1970s were mainly academic studies, including a report by the Hunt Commission, which was appointed by President Nixon in 1971, suggesting more competition among financial institutions and a few proposals for more market discipline with deposit insurance. *See, e.g., C. HENNING, supra note 1, at 213-20; see generally Scott & Mayer, Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform, 23 STAN. L. REV. 857, 886-901 (1971).* Limited deregulation and deposit lending rivalry occurred in the later 1970s, along with somewhat more interest rate rivalry, including NOW accounts. But inflation, higher interest rates, and Money Market Mutual Funds finally forced an end to Regulation Q interest rate ceilings. This allowed more competition among banks and thrifts, and ended regulatory ceilings for deposit interest rates. The Depository Institutions and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 were key milestones. *See W. LOVEIT, BANKING, supra note 1, at 153-78.*

During the Reagan administration (1981-88), controversies developed over further deregulation, market disciplines, risk-related deposit insurance, and capital requirements. *See generally G. BENSTON, supra note 1, at 258-89; C. GOLEMBE & D. HOLLAND, supra note 1, at 278-79; C. HENNING, supra note 1, at 530-35; D. KIDWELL & R. PETERSON, supra note 1, at 237-38; W. LOVEIT, BANKING, supra note 1, at 122-28; M. MALLOY, 1 THE CORPORATE LAW OF BANKS § 1.4 (1988); T. MAYER, supra note 1, at 394-99; I. SPRAGUE, supra note 1, at 261.* For additional highlights on problems of risk-discipline for banks and financial institutions, *see G. BENSTON, supra note 1, at 227-43; N. LASH, supra note 1, at 102-25; see generally E. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 12-24, 112-17, 158-60 (1985); Baer, Private Prices, Public Insurance: The Pricing of Federal Deposit Insurance, ECON. PERSP. (Fed. Reserve Bank of Chicago), Sept.-Oct. 1985, at 56; Baer & Brewer, Uninsured Deposits as a Source of Market Discipline: Some New Evidence, ECON. PERSP. (Fed. Reserve Bank of Chicago), Sept.-Oct. 1986, at 23; Cobos, Cooke, Mitchell, Sexton & Silverberg, Market Discipline and the Federal Deposit Insurance System, in DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT III-1 (Federal Deposit Insurance Corporation ed. 1983); Cooke, Risk-Related Insurance Premiums, in DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT II-1 (Federal Deposit Insurance Corporation ed. 1983); Insuring Confidence—Deposit Insurance Reform, 5 ANN. REV. BANKING LAW 111 (1986); Isaac, The Role of Deposit Insurance in the Emerging Financial Services Industry, 1 YALE J. ON REG. 195 (1984); Kareken, Deposit Insurance Reform or Deregulation is the Cart, Not the Horse, Q. REV. (Fed. Reserve Bank of Minneapolis), Spring 1983, at 1; Kaufman, The Federal Safety Net: Not for Banks Only, ECON. PERSP. (Fed. Reserve Bank of Chicago), Nov.-Dec. 1987, at 25-27; Keeton, Deposit Insurance and the Deregulation of Deposit Rates, ECON. REV. (Fed. Reserve Bank of Kansas City), Apr. 1984, at 28; Comment, The "Brokered Deposit" Regulation: A Response to the FDIC's and FHLBB's Efforts to Limit Deposit Insurance, 33 UCLA L. REV. 594 (1985). But cf. R. BRUMBAUGH, THRIFTS UNDER SIEGE 113-28 (1988); Congress Should Concentrate on Deposit Insurance Reform, FHLBB Lawyer Tells ABA, [July-Dec.] Banking Rep. (BNA) No. 51, at 266 (Aug. 15, 1988) [hereinafter Congress Should Concentrate]; National Council Rejects Quick-Fix Approach to Deposit Insurance Reform, Wash. Fin. Rep. (BNA) No. 44, at 409 (Mar. 11, 1985) [hereinafter National Council].*

Between July 1982 and July 1983 (from the Penn Square failure through the bailout of Continental Illinois), federal bank regulations allowed substantial losses for some large depositors, who were uninsured over the \$100,000 limit as a means of strengthening market discipline. But when a really big bank, the seventh largest in the U.S., threatened to collapse, with large foreign and U.S. business deposits that were mostly uninsured, the shock to American capital markets and confidence in U.S. banking was felt to be too great. Since then, federal regulators have bailed out most larger institutions, or at least prevented the larger, uninsured depositors from suffering significant losses. This has weakened market discipline again and forced bank regulators to adhere to a more traditional and balanced blend of strong depositor protection, strengthened capital adequacy (including subordinated debt assuming capital risks), increased deposit insurance funds, improved supervision, increased disclosure, recommendations for including foreign deposits in the insurance-premium base, and limited variations in insurance premium charges to reflect risk. Since 1987-88, risk-based capital requirements have been implemented. *See, e.g., Healey, Recommendations for Change, 5 ANN. REV. OF BANKING L. 133 (1986)* (summary of recommended changes in deposit insurance by the Treasury Department's Cabinet Council on Economic Affairs, January 1985, which clearly illustrates this return to a more balanced blend of bank supervision and prudential safeguards).

11. *Final International Risk-Based Capital Standards Adopted by the Basle Committee on Banking Regulations*, [July-Dec.] Banking Rep. (BNA) No. 51, at 143 (July 25, 1988) [hereinafter *Basle Risk-Based Capital Standards*]; *see, e.g., Basle Committee Issues Final Risk-Based Capital Standards*, [July-Dec.] Banking Rep. (BNA) No. 51, at 135 (July

compromise agreement between G-12 central banks and finance ministries is a major breakthrough toward a more level playing field for international banking. It also helps to ameliorate some of the more "painful" potential in emerging U.S. bank capital requirements. Fortunately, most healthy U.S. banks are already in compliance with these requirements. Only a few of the largest U.S. banks that were undercapitalized and afflicted with excessive LDC loans in their asset portfolios during the early 1980s are slightly pinched by the new G-12 requirements. When properly understood, even their difficulties are not too serious during the transition period of implementation between 1988 and 1992.<sup>12</sup>

Now, the more interesting question is how to handle capital requirements for bank holding companies as they venture into more securities distribution activities. Recently, many of the largest U.S. banks and bank holding companies have been pressing hard for greater securities powers.<sup>13</sup> Between 1983 and 1986, many large

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25, 1988) [hereinafter *Basle Committee*]; *Central Bankers Approve Risk-Related Capital Standards to Govern 12 Countries*, [July-Dec.] Banking Rep. (BNA) No. 51, at 101 (July 18, 1988) [hereinafter *Central Bankers*]; *Fed May Let BHCs Diverge from New Risk Capital Rules on Certain Preferred Stock*, [July-Dec.] Banking Rep. (BNA) No. 51, at 79 (July 18, 1988) [hereinafter *Fed May Let*]; Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75 (1988); see also *Fed Adopts Risk-Based Capital Concept, Agrees to Leeway for Bank Holding Cos.*, [July-Dec.] Banking Rep. (BNA) No. 51, at 201 (Aug. 8, 1988) [hereinafter *Fed Adopts Risk-Based*]; *Fed Staff Summary and Recommendations on Risk-Based Capital Plan*, [July-Dec.] Banking Rep. (BNA) No. 51, at 232 (Aug. 8, 1988) (adopted by the Federal Reserve Board) [hereinafter *Fed Staff Summary*]; see generally Bardos, *The Risk-Based Capital Agreement: A Further Step Towards Policy Convergence*, Q. REV. (Fed. Reserve Bank of New York), Winter 1987-88, at 26; Keeley, *Bank Capital Regulation in the Early 1980's*, FRBSF WEEKLY LETTER (Fed. Reserve Bank of San Francisco), Jan. 22, 1988, at 1.

12. Most of the "pinching" involves the largest U.S. multinational banks and comes from their lower capitalization in the early 1980s and substantial losses on LDC loans. See, e.g., W. LOVETT, BANKING, *supra* note 1, at 119-21; Forde, *Citicorp Puts Competitors on the Spot*, Am. Banker, Aug. 20, 1987, at 2, col. 2. In 1987, the top ten U.S. bank holding companies took nearly \$10 billion in losses on Third World loans and reduced their shareholder equity (traditional common stock) capital by almost \$10 billion during the second quarter of 1987, i.e., from \$37,468 million to \$27,521 million. *Id.* See also App. Table I and II.

But the Basle G-12 guidelines, as implemented by the Federal Reserve, allow enough leeway for preferred stock issues, subordinated debt, and provisional loan loss reserves so that even the large U.S. multinational banks can mobilize ample noncommon stock capital through 1992 and beyond. The lower risk weights for many assets provide for the easing of bank burdens. See *infra* notes 58-66 and 69-70 and accompanying text.

Nonetheless, some bank and financial commentators have grumbled about unfavorable consequences associated with adoption of the new capital standards. See, e.g., Blander, *Ironing Out Those Troublesome Bumps*, THE BANKER, Feb. 1988, at 56; Humphrey & Humphrey, *How Risk-Based Capital Will Affect Operations*, THE BANKERS MAG., Mar.-Apr. 1988, at 22; Byron, *Capital Guidelines Could Weaken Banks*, Wall St. J., Apr. 23, 1987, at 32, col. 3; Cates, *Self-Review Is Answer to Unrealistic Capital Policy*, Am. Banker, Apr. 16, 1987, at 4, col. 1; Horvitz, *More is Better as far as Capital Requirements Go*, Am. Banker, Apr. 24, 1986, at 4, col. 1.

Much of the grumbling about the adverse consequences reflects a desire for the highest possible capital leverage or gearing ratio and the greatest profit potential, regardless of the risks imposed upon depositors, the economy, and society at large. For a more balanced view, see Howcroft, *UK Bank Capital Adequacy and the Convergent Proposals*, 2 J. INT'L BANKING L. 203 (1987). The most naive critics seem to believe that private "market analysts" could replace banking supervision, government deposit insurance, prudential regulation, and central bank support. Their basic blunder is to assume that outsiders—depositors, analysts, and the market—can easily supervise banks and their asset portfolios. This is simply nonsense! In fact, this activity requires substantial skill and knowledge, not readily developed by outsiders. Centuries of business history before 1933, and ample financial experience since the U.S. strengthened bank deposit-insurance and regulation demonstrate that safe, sound, responsible banking does not happen magically all by itself.

But, of course, no one should believe that risk-based capital requirements, or any other constraint, could operate as the sole guarantor of responsible banking. The point is, rather, that supervision and prudential requirements need blending together. In this regard, see Taggart & Greenbaum, *Bank Capital and Public Regulation*, 10 J. MONEY, CREDIT & BANKING 158 (1978).

13. See generally *Reform of the Nation's Banking and Financial Systems: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban*

banks lobbied strongly for the Garn Bill that would have allowed interstate financial conglomerates. Although this federal drive for broader powers largely failed in Congress, bigger banks were winning a fight for more interstate banking authority in many state legislatures. Then during 1987 and 1988, the Federal Reserve, with Supreme Court approval, broadened bank holding company securities powers through wider regulatory interpretations. During spring 1988, the Proxmire Bill passed the U.S. Senate to allow much broader securities powers for bank holding companies, although with greater supervision and "firewalls" between banking and securities. While there was tougher opposition in the U.S. House of Representatives to weakening the Glass-Steagall wall and permitting greatly enlarged bank securities powers, it seems likely that broader securities powers for banks and bank holding companies, *along with strengthened firewalls* would develop in the later 1980s or early 1990s.<sup>14</sup> (The extent to which "full-service financial conglomerates" might be allowed is more doubtful (*e.g.*, the extent to which bank incursions into the insurance industry would be permissible).<sup>15</sup> Further, the potential for commercial and

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*Affairs*, 100th Cong., 1st and 2d Sess. (1987-88) (parts I-IV) [hereinafter *Reform Hearings*]; W. LOVETT, *BANKING*, *supra* note 1, at 434-56; DEREGULATING FINANCIAL SERVICES (G. Kaufman & R. Kormendi eds. 1986) (especially *Final Report and Recommendations* at 191-201); *Direction of the Financial Services Industry*, 18 LOYOLA L.A.L. REV. 965-1193 (1985); *Financial Restructuring*, CHALLENGE, Nov.-Dec. 1987, at 4-43. These materials reflect almost all the divergent views and conflicting interests on financial markets and possible restructuring. For established boundaries, see M. MALLOY, 2 THE CORPORATE LAW OF BANKS § 7 (1988 & Supp. 1988). See also 38 BANK EXPANSION Q. 21-24, and 56-57 (1st Quarter 1988).

14. For recent legislative developments, see Cranford, *Weary House Panel OKs Bank-Deregulation Bill*, Cong. Q. Weekly Rep. (CQI) at 2096 (July 30, 1988); *Dingell Promises Energy and Commerce Won't Obstruct Action on Banking Bill*, [July-Dec.] Banking Rep. (BNA) No. 51, at 251 (Aug. 15, 1988) [hereinafter *Dingell Promises*]; *Report on Banking Reform Bill Reflects Ongoing Divisions on Banking Committee*, [July-Dec.] Banking Rep. (BNA) No. 51, at 257 (Aug. 15, 1988) [hereinafter *Ongoing Divisions*]. But see Rapp, *Bill on New Bank Powers Dies, Taking Thrift Commission With It*, Cong. Q. Weekly Rep. (CQI) at 3064 (Oct. 22, 1988). On the issue of "firewalls," discussed frequently in *Reform Hearings*, *supra* note 13, see R. LITAN, WHAT SHOULD BANKS DO? 145-48 (1987); Litan, *Evaluating and Controlling the Risks of Financial Products Deregulation*, 3 YALE J. ON REG. 1, 41-42 (1985); Sprague, *American Megabanks: Scary*, *Not Scarce*, Wall St. J., July 15, 1987, at 28, col. 3.

15. For introductions to insurance and pension regulation, see, *e.g.*, W. LOVETT, *BANKING*, *supra* note 1, at 338-79, 422-56. For discussion of the problems of commingling the banking and insurance industry, see, *e.g.*, *Reform Hearings*, *supra* note 13, part 3, at 1-86 (testimony of William V. Irons, William A. Lovett, and Warren Wise). For further information on insurance and pension regulation, see also K. BLACK & H. SKIPPER, *LIFE INSURANCE* 568-90 (11th ed. 1987); M. DORFMAN, *INTRODUCTION TO INSURANCE* 410-30 (3d ed. 1987); A. MUNNELL, *THE ECONOMICS OF PRIVATE PENSIONS* 130-49 (1982); G. REIDA, *PRINCIPLES OF INSURANCE* 581-99 (2d ed. 1986); A. TOBIAS, *THE INVISIBLE BANKERS* 246-76 (1982). Insurance industry opposition to allowing banks into their markets is widespread, especially from the 250,000-strong network of independent insurance agencies, together with the large "direct writer" big company sales forces. These marketing establishments feel greatly threatened by banks selling insurance policies. Their spokesmen fear unfair competition and the dangers of tying bank loans, credit, and deposit accounts to insurance policies. At the underwriting or insurance company level, for example, the level concerned with the maintenance of adequate reserves, administration, and investment programs, there also exists extensive opposition to commingling the banking and insurance industries. After the Dodd Amendment victory in 1984, when a large majority of the U.S. Senate refused to allow bank holding companies into most insurance markets, the bank diversification lobby has concentrated mainly on securities powers, with insurance powers a longer term objective.

Public interest questions are very important. Would the integrity of insurance industry reserves, investments, and reliability be threatened if a stampede of merger activity, takeovers, and scrambled financial service conglomerates were allowed? To what extent would financial concentration, already higher in securities and insurance than in banking, be increased? How would competition suffer in the long run from substantial increases in concentration and increasing difficulty for new entrants to compete against giant financial conglomerates? What would happen to customer service and reliability, pricing, and fees? Are there any significant scale economies in the formation of giant financial conglomerates? See, *e.g.*, *Reform Hearings*, *supra* note 13, part 3, at 210 (testimony of William A. Lovett). For further information on scale economies in banking, see, *e.g.*, Shepherd & Heggestad, *The Banking Industry*, in *THE STRUCTURE OF AMERICAN INDUSTRY* 290, 304-15 (W. Adams 7th ed. 1986) (introduction to the literature); see also Benston, Hanweck & Humphrey,

industrial conglomerates to merge with banks and bank holding companies is quite up in the air.)<sup>16</sup>

This left important ambiguities and problems for Congress and bank regulators. If strengthened risk-based capital requirements are the evolving solution to moral hazard problems in financial institutions, along with renewed supervision discipline and reasonable accountability, how should securities underwriting and marketing activities by banks, bank holding companies, and financial service conglomerates be risk-rated? What capital requirements are appropriate for securities firms, and how, if at all, should capital requirements be meshed between bank-securities operations? A more complex, troublesome question is how, if at all, capital requirements should be defined, enforced, and maintained for financial-general business conglomerates (if these are to be allowed into ownership of bank holding companies or financial service holding companies)? Modern experience with bank supervision, safety, and soundness has demonstrated extensively that conglomerate business misfortunes and severe losses are very hard to keep separate from a bank controlled by the same interests. Almost inevitably, a failing or troubled conglomerate uses its bank, lending authority, or loan guarantees to prop up or keep the general business afloat for at least a little while longer. This substantial and continuing danger, in fact, is one of the major reasons why modern banking laws tried to keep banking and fiduciary

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*Scale Economies in Banking*, 14 J. MONEY, CREDIT & BANKING 435 (1982); McCall, *Economies of Scale, Operating Efficiencies and the Organizational Structure of Commercial Banks*, 11 J. BANK RES. 95 (1980).

Recently, some bankers contend that potential economies from diversification might exceed previously experienced scale economies. One reason is a claim that capital reserves can be reduced for very large institutions, *i.e.*, that higher levels of leveraging should be permitted for the largest banks or financial holding companies and not allowed for smaller institutions. But the risk of default on loans or investments by the larger institutions is still similar and big financial bureaucracies are just as capable of errors in judgment. There have been major difficulties since 1982 for the largest U.S. multinational banks with regard to excessive loans to Latin American and developing country borrowers. This insecure lending substantially exceeded the capital resources of the ten largest U.S. banks. For political and economic reasons, of course, the largest banks were not allowed to fail. *See, e.g.*, I. SPRAGUE, *supra* note 1, at 149-228 (description of Continental Illinois receivership). But a policy of not allowing the largest institutions to fail is hardly proof of efficiency; it merely reflects favoritism and direct subsidies in regulation, and somewhat weakens the normal moral hazard for failure and bad management.

A more limited possibility is operating economies achieved through adding products or services that are delivered by existing institutions such as banks, thrifts, securities firms, mutual funds, insurance companies and agencies, and pension organizations. Efficiency gains are feasible in this direction. But many of these gains for winning institutions will be losses for other institutions. While many jobs and profits may be reshuffled, lost, and won through financial "turf wars," the real gains to the public may be speculative and are likely to be overstated.

16. Many banking experts oppose the integration of deposit-insured banking with nonfinancial conglomerates involving industry and marketing at this stage. *See, e.g.*, W. LOVETT, *BANKING*, *supra* note 1, at 434-56; Corrigan, *Keep Banking Apart*, CHALLENGE, Nov.-Dec. 1987, at 28; Dingell *Promises*, *supra* note 14, at 251; *Final Report and Recommendations*, in DEREGULATING FINANCIAL SERVICES 191 (G. Kaufman & R. Kormendi eds. 1986); Litan, *supra* note 14, at 19-34; Litan, *Which Way for Congress?*, CHALLENGE, Nov.-Dec. 1987, at 36; Lovett, *Federalism, Boundary Conflicts and Responsible Financial Regulation*, 18 LOYOLA L.A.L. REV. 1053 (1985); *Ongoing Divisions*, *supra* note 14, at 257; Rhoades, *Interstate Banking and Product Line Expansion: Implications from Available Evidence*, 18 LOYOLA L.A.L. REV. 1115 (1985); Tobin, *A Case for Preserving Regulatory Distinctions*, CHALLENGE, Nov.-Dec. 1987, at 10; Sprague, *supra* note 14, at 28, col. 3. But a few leading insurance companies, including Allstate, Sears Roebuck, Dean Witter, and Coldwell Banker already cross these boundaries. If we allow banks to be scrambled generally into securities firms and then into insurance and pension fund operations, will it be feasible to prevent conglomerates generally from owning financial service holding companies? Can effective firewalls be maintained and safeguarded between financial and nonfinancial activities?

For a classic case history on the difficulty of insulating a bank from its conglomerate owner's problems, see J. WHITE, *TEACHING MATERIALS ON BANKING LAW* 833-47 (1976) (United States National Bank and Franklin National Bank).

activities separate from, and uncontaminated by, general conglomerate and more risky business enterprises.<sup>17</sup>

Perhaps bank capital owners want to make some bolder, more diversified investments. Fine, let them do so! But the broader avenue for investment diversification under modern banking law in the U.S. has been through separate investments, independently selected by individual bank shareholders and owners. It has been considered unsound since the Glass-Steagall Act of 1933 for commercial banks and bank holding companies—fiduciary institutions holding themselves out as safe and sound depository institutions to the general public, with their deposits government-insured by the FDIC and FSLIC (Federal Savings & Loan Insurance Corporation), and more generally “supported” against failure by the Federal Reserve—to make speculative investments with depositor funds. This has meant that banks are “special,” more carefully regulated, and properly insured by government for the general benefit of financial stability and prosperity. How can this closely supervised, government-insured banking business, with stronger risk-based capital requirements, be loosely integrated into general commerce? Further, if we allow more integration and diversification into securities investment and marketing, what kind of “firewalls,” accountability, and extended risk-based capital requirements are appropriate?<sup>18</sup>

## II. MACROECONOMICS AND THE PUBLIC RESPONSIBILITIES OF BANKING

Banking and depository institutions provide important services to their communities and the public-at-large. Liquid assets, including specie and currency owned by individuals, private business, and corporate enterprise are more efficiently safeguarded and profitably reinvested by specialized institutions such as commercial banks, savings banks, savings and loans, and credit unions. Banking institutions traditionally reloan liquid deposits from the public to business, farmers, home and other property buyers, working families, and consumer households. So long as good collateral or security assures that the loan principal and interest can be repaid to banking institutions, their balance sheets remain solvent. A small default rate is acceptable with adequate loan loss reserves. With enough “cash” (specie, currency, Federal Reserve deposits, or correspondent bank accounts) and sufficient marketable securities (government bonds and high-grade corporate bonds) in the asset portfolio, a bank’s solvency in the liquidity sense is secured. This allows banks to invest the majority of their assets more profitably in general loans, trade finance, or risk guarantees somewhat more aggressively but without undue risk. Highly speculative

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17. See, e.g., Corrigan, *supra* note 16, at 28; Sprague, *supra* note 14, at 28.

18. To the extent boundaries are allowed to erode between banking and securities activities, and perhaps, between these fields and insurance, pension funds, and other industries, the central questions for responsible supervision policy will become accountability, capital requirements, permissible leverage, and the flow of funds and *potential liabilities* between these activities. Resolving these issues will define the playing field for competition and establish the margins for profit and survival among financial intermediaries. Thus, “firewalls,” safeguards against bank holding company vulnerability and the protection of deposit insurance funds, become crucial issues. See *Reform Hearings*, *supra* note 13, part 3, at 42–86 (testimony of William A. Lovett); R. LITAN, *supra* note 14, at 144–89; Corrigan, *supra* note 16, at 28; Litan, *supra* note 14, at 41–42.



investments with great uncertainty or downside risk, however, are not considered appropriate for banking institutions because banks must stand ready to redeem customer deposits.<sup>19</sup>

The privilege of fractional reserve banking, with limited liability bank corporations or holding companies, allows highly leveraged profit-making for bank leaders and stockholders. Yet this multiplies the supply of "bank money," commercial, and other credits from banking institutions to society, which thereby encourages industrial activity, trade, and general prosperity, provided that liquidity and credit expansion is not carried to inflationary or speculative excess. Modern central banks, like the Federal Reserve, regulate aggregate monetary growth and credit availability for this reason.<sup>20</sup>

To prevent undue profit in banking we allow considerable competition and relatively free entry (under chartering and supervisory safeguards). This narrows the range for the bank profitability and fosters rivalry and innovation to improve banking services. On the other hand, completely unrestricted entry, over-banking, and cutthroat competition weakens bank earnings and frequently leads to speculative or imprudent lending.<sup>21</sup> This would conflict with the goals of reasonable stability and reliability for banking. Accordingly, chartering procedures and bank supervision try to ensure adequate capitalization, responsible management, and reasonable performance.<sup>22</sup> Losses should be minimized and bank regulators should impose corrective measures or change leadership before a bank's capital is wasted on bad or loss loans accounts.<sup>23</sup> In this way, the potential liability to the government's deposit insurance agencies (such as the FDIC, FSLIC, and NCUSIF (National Credit Union Share Insurance Fund)) may be minimized and premium costs for deposit insurance held to low levels.

Modern bank regulation, lender-of-last-resort support, and government deposit insurance evolved through a series of financial panics and depressions, culminating in the worldwide depression of the 1930s. Most industrial nations found themselves suffering heavy unemployment, reduced prosperity, and painful social conflicts. From this learning experience came improved macroeconomic thinking, and the practice of modern central banks and treasury ministries to keep aggregate spending and liquidity growing within moderate, sustainable levels. The Great Depression taught that purchasing power, liquidity, and aggregate demand should be sustained by

19. See J. GALBRAITH, *supra* note 1, at 173-84; C. GOLEMBE & D. HOLLAND, *supra* note 1, at 69-76; C. HENNING, *supra* note 1, at 487-96; D. KIDWELL & R. PETERSON, *supra* note 1, at 89-97; N. LASH, *supra* note 1, at 23; W. LOVETT, *BANKING*, *supra* note 1, at 118-28; T. MAYER, *supra* note 1, at 19-24.

20. See J. GALBRAITH, *supra* note 1, at 125-27; C. HENNING, *supra* note 1, at 172-77; D. KIDWELL & R. PETERSON, *supra* note 1, at 131-51; N. LASH, *supra* note 1, at 78-84; W. LOVETT, *BANKING*, *supra* note 1, at 55-90; T. MAYER, *supra* note 1, at 174-80, 327-29; see also W. GREIDER, *SECRETS OF THE TEMPLE* 355-60 (1987); S. HYMAN, *supra* note 1, at 326-30; D. KETTL, *LEADERSHIP AT THE FED* 4-5, 175-76 (1985); W. MELTON, *INSIDE THE FED* 43-57 (1985).

21. See C. GOLEMBE & D. HOLLAND, *supra* note 1, at 93-107, 131-89; W. LOVETT, *BANKING*, *supra* note 1, at 110-44, 451-56; M. MALLOY, *supra* note 13, at §§ 8-9.

22. See C. GOLEMBE & D. HOLLAND, *supra* note 1, at 93-107, 269-81; W. LOVETT, *BANKING*, *supra* note 1, at 113-21; M. MALLOY, *supra* note 1, at § 2; M. MALLOY, *supra* note 13, at § 10.

23. See G. BENSTON, *supra* note 1, at 91-108, 245-72; I. SPRAGUE, *supra* note 1, at 232-34; see also C. GOLEMBE & D. HOLLAND, *supra* note 1, at 69-76.

government deficits, if necessary, to prevent excessive slumps or unemployment.<sup>24</sup> Governments also fashion tax policies and other inducements to encourage industrial expansion and broader prosperity.<sup>25</sup> Employment and manpower training policies may help jobs and opportunities grow with the economy.<sup>26</sup> During the 1950s and 1960s, most OECD (Organization of Economic Cooperation and Development) countries achieved stronger economic growth and relatively low unemployment with only modest inflation.<sup>27</sup> But in the 1970s, inflation grew more serious, often with excessive government deficits, a wage-price spiral, scarcities in commodity markets, and yet unemployment tended to increase. "Stagflation" afflicted many OECD nations, with greater inflation and unemployment, and declining productivity in some sectors.<sup>28</sup> Finally, in the 1980s, restricted monetary growth, higher interest rates, and deflation slowed greatly the inflationary momentum of the 1970s. The wage-price spiral declined, with more competition from low-wage new industrial countries, forcing greater productivity discipline. Somewhat higher unemployment, compared to the 1950s and 1960s, also combined with weaker unions to reduce "wage" inflation in many industrial nations.<sup>29</sup>

Other developments picking up momentum in the 1980s were greater international movements of capital, investment, and liquidity. A more open, global, and diversified marketplace brought many opportunities for trade and export/import

24. See J. GALBRAITH, *supra* note 1, at 214-15, 286-92, 305-11; C. GOLEMBE & D. HOLLAND, *supra* note 1, at 8-9; W. GREIDER, *supra* note 20, at 420-25; C. HENNING, *supra* note 1, at 517-52; D. KETTL, *supra* note 20, at 109-12, 173-79; D. KIDWELL & R. PETERSON, *supra* note 1, at 538-42; N. LASH, *supra* note 1, at 11-21; W. LOVETT, *BANKING*, *supra* note 1, at 51-61; T. MAYER, *supra* note 1, at 301-20, 374-99; W. MELTON, *supra* note 20, at 138-49; see generally R. DALE, *supra* note 1; S. HYMAN, *supra* note 1; P. STUDENSKI & H. KROOS, *supra* note 1.

25. See A. ANDO, M. BLUME & I. FRIEND, *THE STRUCTURE AND REFORM OF THE U.S. TAX SYSTEM* 5-9 (1985); J. MAXWELL & J. ARONSON, *FINANCING STATE AND LOCAL GOVERNMENTS* 10-30 (3d ed. 1977); J. PECHMAN, *FEDERAL TAX POLICY* 5-7, 27-37 (5th ed. 1987).

26. Manpower training and pro-employment policies received greater emphasis and budgetary support in the later 1960s and the 1970s, and have been cut back, with more reliance on free markets, in the 1980s. But how to provide more jobs and good wages was still a big issue in the 1988 presidential campaign. See, e.g., M. DUKAKIS & R. KANTER, *CREATING THE FUTURE* 54-82, 107-56 (1988) (emphasis placed upon government-business partnership). In contrast, most Republicans favor more modest government effort in this area. See, e.g., The Kennedy-Quayle employee training legislation enacted in 1982 known as the Job Training Partnership Act, 29 U.S.C.A. §§ 1501-1781 (West 1985). See also Alter, Padgett, King & Noah, *Who Is Dan Quayle?*, *NEWSWEEK*, Aug. 29, 1988, at 22, 25.

27. See, e.g., A. BROWN, *WORLD INFLATION SINCE 1950*, at 347-50 (1985); W. LOVETT, *INFLATION AND POLITICS* 11-27 (1982) [hereinafter W. LOVETT, *INFLATION*]; L. REYNOLDS, *ECONOMIC GROWTH IN THE THIRD WORLD, 1850-1980*, at 36-38 (1985); see generally S. LIEBERMAN, *THE GROWTH OF EUROPEAN MIXED ECONOMIES 1945-1970* (1977).

28. See, e.g., A. BROWN, *supra* note 27, at 362-64; W. LOVETT, *INFLATION*, *supra* note 27, at 25-27; L. REYNOLDS, *supra* note 27, at 36-38; see also R. FLANAGAN, D. SOSKICE & L. ULMAN, *UNIONISM, ECONOMIC STABILIZATION, AND INCOMES POLICIES* 5-36 (1983) [hereinafter R. FLANAGAN]; G. HABERLER, *THE PROBLEM OF STAGFLATION* 71-74 (1985); Denison, *Accounting for Slower Economic Growth: An Update*, in *INTERNATIONAL COMPARISONS OF PRODUCTIVITY AND CAUSES OF THE SLOWDOWN* 1, 29-34 (J. Kendrick ed. 1984); Maier, *Inflation and Stagnation as Politics and History*, in *THE POLITICS OF INFLATION AND ECONOMIC STAGNATION* 3, 14-18 (L. Lindberg & C. Maier eds. 1985); see generally S. LIEBERMAN, *supra* note 27.

29. See A. BROWN, *supra* note 27, at 220-32; R. FLANAGAN, *supra* note 28, at 5-36; G. HABERLER, *supra* note 28, at 71-74; W. LOVETT, *INFLATION*, *supra* note 27, at 73-85; Barry, *Does Democracy Cause Inflation? Political Ideas of Some Economists*, in *THE POLITICS OF INFLATION AND ECONOMIC STAGNATION*, *supra* note 28, at 280, 297-307; Mills, *U.S. and European Approaches to Improving Productivity and the Quality of Work Life*, in *INTERNATIONAL COMPARISONS OF PRODUCTIVITY AND CAUSES OF THE SLOWDOWN*, *supra* note 28, at 361. For the growing importance of world market competition, often sponsored by foreign industrial policies and low wage rivalries, see W. LOVETT, *WORLD TRADE RIVALRY* 53, 183-85, 212-17 (1987) [hereinafter W. LOVETT, *TRADE*]. For recent U.S. macroeconomic developments, see B. BLUESTONE & B. HARRISON, *THE GREAT AMERICAN JOB MACHINE: THE PROLIFERATION OF LOW-WAGE EMPLOYMENT IN THE U.S. ECONOMY* 4, 38 (1986); W. LOVETT, *BANKING*, *supra* note 1, at 73-85.

expansion. But Japan, West Germany, Switzerland, and many New Industrial Countries (NICs) benefitted more than other OECD nations (including Great Britain and the U.S.). The most successful nations geared their economic policies, interest rates, and exchange rates to promote stronger, long-term economic growth and export expansion.<sup>30</sup>

Lately, awkward problems for the U.S. have been excessive government budget deficits with higher U.S. interest rates and increased U.S. dependence on foreign borrowing. Between 1982 and 1988, U.S. federal deficits exceeded \$1,100 billion, and approached \$200 billion annually (nearly five percent of GNP) between 1983 and 1987. The U.S. switched from the largest creditor nation to the largest debtor nation. While the U.S. got by with heavy foreign borrowing and capital inflows, U.S. exports were weakened, imports surged, and a stubborn trade deficit followed. Since early 1985, the U.S. dollar depreciated by almost fifty percent against strong foreign currencies such as the Japanese yen, German deutschmark, and Swiss franc. A substantial premium developed in U.S. interest rates over hard currency rates. This increased costs for domestic American manufacturers and greatly complicated rescheduling of Latin American debts, which heavily involved most leading U.S. multinational banks.<sup>31</sup>

Unfortunately, the prime source of excessive U.S. budget deficits is a serious, unresolved conflict over spending priorities and tax loads that developed in the Reagan era.<sup>32</sup> President Reagan wanted substantially increased defense spending, a thirty percent income tax cut, and major reductions in civilian spending other than basic social security (Old Age Survivors, Disability and Health Insurance), which has its own payroll tax revenues. Congress accepted most of the defense increases and tax cuts, but was unable to cut civilian spending enough to offset a major widening of the federal deficit. Reagan sought further civilian spending cuts by seeking a line-item veto authority to make cuts without Congressional agreement, but Congress refused to delegate its spending power to the President. Mondale, the Democratic candidate, wanted to raise taxes in 1984, but Reagan counterattacked by saying he would accept

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30. See W. LOVETT, *TRADE*, *supra* note 29, at 8-14; see also Packard, *The Coming U.S.-Japan Crisis*, 66 FOREIGN AFF. 348, 351-53 (1987); Van Wolferen, *The Japan Problem*, 65 FOREIGN AFF. 288, 291-95 (1986). For additional insights into the superior economic performance of Japan, West Germany, and Switzerland, see W. LOVETT, *INFLATION*, *supra* note 27, at 147-68.

31. See J. FAUX, *GETTING RID OF THE TRADE DEFICIT: A CHEAPER DOLLAR IS NOT ENOUGH I* (1988); INSTITUTE FOR INTERNATIONAL ECONOMICS, *RESOLVING THE GLOBAL ECONOMIC CRISIS: AFTER WALL STREET I* (1987); W. LOVETT, *INFLATION*, *supra* note 27, at 147-68; W. LOVETT, *TRADE*, *supra* note 29, at 190; S. MARRIS, *DEFICITS AND THE DOLLAR: THE WORLD ECONOMY AT RISK* 105-27 (1987); Bergsten, *Economic Imbalances and World Politics*, 65 FOREIGN AFF. 770, 774 (1987); Cumby & Levich, *Definitions and Magnitudes*, in *CAPITAL FLIGHT AND THIRD WORLD DEBT* 27 (D. Lessard & J. Williamson eds. 1987); Reich, *The Economics of Illusion and the Illusion of Economics*, 66 FOREIGN AFF. 516, 523-24 (1988); Silk, *The U.S. and the World Economy*, 65 FOREIGN AFF. 458, 462 (1987); Van Wolferen, *supra* note 30, at 298-99.

32. INSTITUTE FOR INTERNATIONAL ECONOMICS, *supra* note 31, at 1; W. LOVETT, *INFLATION*, *supra* note 27, at 195-207; S. MARRIS, *supra* note 31, at 35; Bergsten, *supra* note 31, at 770; Rapp, *Deficit Limits Reagan's Options in 1989 Budget*, Cong. Q. Weekly Rep. (CQI) at 327 (Feb. 20, 1988) [hereinafter Rapp, *Deficit Limits*]; Rapp, *House Panel Turns Creative to Craft Fiscal 1989 Measure*, Cong. Q. Weekly Rep. (CQI) at 726 (Mar. 19, 1988) [hereinafter Rapp, *House Panel*]; Rapp, *OMB Fiscal '89 Budget Report Puts Hill Democrats in a Bind*, Cong. Q. Weekly Rep. (CQI) at 2089 (1988) [hereinafter Rapp, *OMB Fiscal*]; Reich, *supra* note 31, at 516; Silk, *supra* note 31, at 459-60; Volcker, *Facing Up to the Twin Deficits*, CHALLENGE, Special Anniversary Issue 1987, at 31; Walsh, *Do Deficits Really Matter?*, FRBSF WEEKLY LETTER (Fed. Reserve Bank of San Francisco), Jan. 15, 1988, at 1.

tax increases only as a last resort. When Reagan won a landslide election in November 1984, this greatly discouraged any other presidential candidate from offering to raise taxes. In this situation, the Gramm-Rudman compromise of 1985 was designed to phase in gradual spending reductions over five years. But the conflict between Reagan and Congressional Democrats continued and implementation has been weak. In 1988, the U.S. federal budget deficit was still somewhere between \$145 and 175 billion including emergency drought relief. Clearly, an excessive budget deficit has been passed along to the next administration.

In this context, American banks and savings institutions suffered a great increase in failure rates during the 1980s.<sup>33</sup> Between 1940 and 1980, only 568 insured banks failed, with only \$6.2 billion of insured deposits; this averaged only fourteen banks yearly out of some 14,500 U.S. banks. This total held relatively constant, with mergers offsetting new entrants. But between 1981 and 1987, 621 insured bank failures occurred involving \$65 billion in deposits. This represented a ten-fold increase in annual failures and a seventy-fold annual increase in the value of deposits involved. Fifteen hundred U.S. banks in 1988 were considered "problem banks," constituting roughly ten percent of the nation's total. In addition, U.S. savings and loans suffered a severe squeeze in the late 1970s between rising interest deposit rates and long-term fixed rate mortgage earnings.<sup>34</sup> By the early 1980s, eighty percent of the Savings & Loans (S & Ls) were losing money and many had depleted capital and reserves. Fortunately, lower interest rates in the mid to late 1980s allowed the majority of thrift institutions to recover, with half of the thrifts converting from mutual to stock institutions to raise more capital. Many S & Ls got into subsequent difficulties, however, with speculative "A,D,C" lending (real estate acquisition, development, and construction loans) encouraged by partial deregulation. Roughly 500 of the 3,000 surviving S & Ls were believed insolvent in the summer of 1988, with losses exceeding current FSLIC reserves. The troubled thrift and banking crisis was most aggravated in the oil-patch states of Texas, Oklahoma, and Louisiana where a previous oil-gas price boom encouraged excessive real estate and commercial development. Some \$50-100 billion in losses may be suffered by financial institutions in these states because oil-gas prices, exploration, and drilling declined so drastically in the mid-1980s. Agricultural banks in much of the Midwest and parts of the West also suffered from reduced commodity prices in most of the 1980s that hurt many farmers and lowered land and collateral values. A large share of bank failures in the 1980s involved small agricultural banks, although these difficulties seemed to be easing in 1988—unless the 1988 summer drought weakened farm incomes.

But why did U.S. banking failures increase so sharply in the 1980s, and what

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33. See W. LOVETT, *BANKING*, *supra* note 1, at 122-28; I. SPRAGUE, *supra* note 1, at 242-62; see generally *Congress Will Provide*, *supra* note 8, at 307; *Financial Condition*, *supra* note 8, at 168; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; Gorman, Hornik & Woodbury, *supra* note 8, at 54; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1.

34. See R. BRUMBAUGH, *supra* note 10, at 31-56; W. LOVETT, *BANKING*, *supra* note 1, at 76-82; I. SPRAGUE, *supra* note 1, at 77-78; see generally Gorman, Hornik & Woodbury, *supra* note 8, at 54.

implications follow for risk-based capital requirements and supervision of financial institutions? Four factors operated:

First, the inflation momentum of the 1970s was broken by strong monetary restraint, widespread recession, and financial stress in the early 1980s for many business enterprises. This weakened loan asset quality in many sectors, especially Latin American lending, the oil-patch, grain-belt, and some Western real estate markets. Then during the economic recovery that developed unevenly in the mid-1980s, with a vigorous stock market boom that was followed by the October 1987 "crash" or downside correction, many businesses "leveraged-up" and increased borrowing. This increased the financial vulnerability of many corporate enterprises and real estate developments.<sup>35</sup>

Second, more banks became aggressive, sought higher earnings, and accepted greater risks. This was partly a result of "expectational momentum" from inflation in the 1970s. But bank managers often became more entrepreneurial and growth-minded, and less conservative in their lending strategies or asset-liability management.<sup>36</sup>

Third, financial regulators were more relaxed and accommodative to bank growth, diversification, and higher interest rate earnings expectations.<sup>37</sup> This outlook dominated the OCC through the Reagan years, and it gradually became more influential at the Federal Reserve Board (Fed) as Reagan appointees were added. This mentality became dominant at the Fed after Paul Volcker was replaced by Allan Greenspan. The higher interest rate environment also responded to excessive U.S. budget deficits from 1983 to 1988, although these deficits were criticized by Volcker and other Fed members.<sup>38</sup> Higher U.S. interest rates were needed to attract foreign capital and prevent any drastic, unduly rapid, or disruptive decline in the dollar's value. Further increases in interest rates have occurred during Greenspan's tenure as Fed Chairman in order to limit inflation, support the dollar, and match rising rates abroad.

Fourth, the U.S. industrial-manufacturing-agricultural economy, the "base" for an expanding service economy, grew unevenly in the 1980s with significant areas of softness.<sup>39</sup> The oil-patch boom plateaued in the early 1980s and collapsed in 1986,

35. See H. KAUFMAN, *INTEREST RATES, THE MARKETS, AND THE NEW FINANCIAL WORLD* 66-80 (1986); W. LOVETT, *BANKING*, *supra* note 1, at 73-85; see generally Bock, Hornik & Svoboda, *supra* note 8, at 61; Gorman, Hornik & Woodbury, *supra* note 8, at 55.

36. See R. BRUMBAUGH, *supra* note 10, at 34-36; H. KAUFMAN, *supra* note 35, at 66-80; W. LOVETT, *BANKING*, *supra* note 1, at 126-28; see generally Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; Gorman, Hornik & Woodbury, *supra* note 8, at 55; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1.

37. This attitude evolved as a response to increased inflation in the later 1970s, the federal government's difficulty in controlling deficits in the 1980s, strains for major U.S. international banks, the stock market boom between 1983 and October 1987, and lobbying pressures from the banking industry.

38. Volcker's warning on deficit dangers was repeated firmly in many public statements from summer 1981 through his resignation as Fed Chairman in summer 1987. See, e.g., Volcker, *supra* note 32, at 33; see also W. GREIDER, *supra* note 20, at 668-86; W. LOVETT, *TRADE*, *supra* note 29, at 227-456. While U.S. interest rates eased substantially during 1985 to 1986, they moved back up appreciably during 1987 to defend the dollar and attract foreign borrowing, eased after the October 1987 stock market crash with widespread fears of recession, but moved back up again from the spring of 1988 through the fall of 1988 to resist inflation, defend the dollar, and attract foreign capital.

39. See INSTITUTE FOR INTERNATIONAL ECONOMICS, *supra* note 31, at 1; W. LOVETT, *BANKING*, *supra* note 1, at 79-85; W. LOVETT, *INFLATION*, *supra* note 27, at 195-207; S. MARRIS, *supra* note 31, at 5-15; Bergsten, *supra* note 31,

with a drastic decline in oil prices. The grain-belt suffered lower prices during the early to late 1980s with widespread distress experienced by farmers, especially those burdened with significant debt loads. Further, significant parts of U.S. manufacturing, often referred to as "smokestack America," remained weak, with increased foreign competition, aggravated by a "high" dollar between 1983 and 1986 and a trend of plant relocations to low wage countries. These "soft" sectors limited economic growth and prosperity in many areas.

To the extent wisdom accumulated in bank regulation between 1935 and 1980 (the modern FDIC-FSLIC era), the major risks of bank failure had been associated with weak management.<sup>40</sup> This included inadequate supervision of departments by top officers and directors; self-dealing transactions and loans to friends, relations, or businesses owned by bank insiders; embezzlement, theft, or fraudulent misappropriation; overly aggressive growth and profit maximizing strategies with excessive risk; unduly concentrated lending portfolios lacking diversification; poor luck in foreign exchange operations caused by insufficient care to minimize risks; or sizeable losses on bad checks, endorsements, or guarantees. These were problems of negligence and breach of fiduciary duties that good professional bankers should always minimize. Stronger regulation and oversight between 1940 and 1980 helped to minimize these problems. Bank failures were infrequent and only a modest burden for government insurance. The U.S. economy experienced broad prosperity and growth between 1940 and 1981 with only short recessions (1948-49, 1953-54, 1957-58, 1959-60, and 1974-75), although there was increased inflation in the later 1960s and 1970s. Due to traditional bank regulatory success, it is understandable that bank regulators were unprepared for growing "systemic risks" during the 1980s.<sup>41</sup>

During the 1980s, however, "systemic risks" increased substantially for many U.S. banks. Bank regulators were surprised about various factors including the extent of "softness" in Latin American-LDC loan portfolios for U.S. multinational banks after July, 1982; the spread of "softness" in U.S. agricultural-farm loans during the 1980s; the softness in U.S. oil-patch loans in the mid to late 1980s; and the softness of many real estate-commercial development loans in Western states (and potentially other areas) during the mid to late 1980s.<sup>42</sup> While Chairman Volcker's speeches between 1982 and 1987 warned of distortions and strains for U.S. manufacturing

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at 788; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; Gorman, Hornik & Woodbury, *supra* note 8, at 54; Noble, *\$3.9 Billion Drought Aid Passes Senate on a 92-0 Vote*, N.Y. Times, Aug. 9, 1988, at A-12, col. 1; see also S. COHEN & J. ZYSMAN, MANUFACTURING MATTERS 59-76 (1987); J. GRUNWALD & K. FLAMM, THE GLOBAL FACTORY 12-21 (1985); *Introduction and Summary*, in COMPETITION IN GLOBAL INDUSTRIES 1 (M. Porter ed. 1986).

40. See G. BENSTON, *supra* note 1, at 1-35; W. LOVETT, BANKING, *supra* note 1, at 122-34.

41. For macroeconomic reviews, see, e.g., W. LOVETT, BANKING, *supra* note 1, at 62-85; see generally C. HENNING, *supra* note 1, at 517-52; D. KIDWELL & R. PETERSON, *supra* note 1, at 75-77, 535-56; T. MAYER, *supra* note 1, at 385-99.

42. See W. LOVETT, BANKING, *supra* note 1, at 126; W. LOVETT, INFLATION, *supra* note 27, at 195-207; W. LOVETT, TRADE, *supra* note 29, at 137; S. MARRIS, *supra* note 31, at 5-15, 170-75; I. SPRAGUE, *supra* note 1, at 203, 226-33; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; Gorman, Hornik & Woodbury, *supra* note 8, at 54; Rodriguez, *Consequences of Capital Flight for Latin American Debtor Countries*, in CAPITAL FLIGHT AND THIRD WORLD DEBT 129 (D. Lessard & J. Williamson eds. 1987); Silk, *supra* note 31, at 460-62; Noble, *supra* note 39, at A-12, col. 1.

resulting from fiscal indiscipline and excess budget deficits, this did not translate into tougher bank supervision by the Fed, OCC, FDIC, or for S & Ls by the Federal Home Loan Bank Board.<sup>43</sup> Perhaps, with hindsight's wisdom, bank regulators should have foreseen the risks of bolder, higher earnings bank growth strategies. But inflationary expectations were entrenched during the later 1970s and built into world market, real estate, farm land, and oil-gas prices. While American history had seen major speculative excesses previously in real estate pricing during the 1830s, post-Civil War period, late 1920s, and early 1970s, long-term scarcity and locational premiums did seem to justify a trend of real estate price increases during the 1980s.<sup>44</sup>

### III. SOLUTIONS TO MORAL HAZARD AND BANKING RISK PROBLEMS

What implications follow for U.S. banking supervision, prudential safeguards, and risk-based capital requirements? The more obvious "managerial" shortcomings, including breach of fiduciary duty, fraud, and negligence, clearly deserve continued oversight and discipline and should be the primary responsibilities of equity capital investors (and those assuming capital risks through preferred stocks, debentures, and notes). Improved supervision and strengthened risk-based capital requirements certainly would help to decrease losses occurring in this area.<sup>45</sup>

But what of "systemic" breakdowns, *e.g.*, world market disruptions, inflation, warfare, unexpected scarcities, depression, or mismanaged macroeconomic and trade policies? Within limits, equity capital holders should expect to shoulder some burdens in an uncertain world, and risk-based capital requirements partly guarantee the solvency of banking institutions. But modern macroeconomics teaches that central banks and treasury ministries should provide ample lender-of-last-resort credit and appropriate deficit finance or other policy measures to ease "systemic" adversities. This implies liberal long-term government credits, with substantial leveraging, to rebuild the capitalization of failed or seriously troubled institutions hit by substantial "systemic" misfortunes.<sup>46</sup>

Thus, when "external shocks"—like OPEC I and II (Organization of Petroleum Exporting Countries) oil-gas price increases, war mobilizations, significant monetary restraint to halt previous inflations, and substantial recessions—impact the economy or cause seriously disruptive interest rate changes that may cause many bank failures,

43. See W. GREIDER, *supra* note 20, at 406–49; W. LOVETT, *TRADE*, *supra* note 29, at 137; Volcker, *supra* note 32, at 31.

44. While some analysts warned that stock prices and PE (price earnings) ratios were too high in the fall of 1987 before the crash, many others were genuinely surprised and still have more optimism.

45. See G. BENSTON, *supra* note 1, at 175–77, 245–71; I. SPRAGUE, *supra* note 1, at 231–64; *see also* R. DALE, *supra* note 1, at 53–70; *General Perspective*, *supra* note 2, at 25; *Supervisory Issues*, in UK BANKING SUPERVISION 46 (E. Gardener ed. 1986) [hereinafter *Supervisory Issues*].

46. See G. BENSTON, *supra* note 1, at 109–26; W. LOVETT, *BANKING*, *supra* note 1, at 51–68, 248–56, 271–76; I. SPRAGUE, *supra* note 1, at 231–64; *see also* R. DALE, *supra* note 1, at 207 (references to Lender-of-Last-Resort in Index); J. GRADY & M. WEALE, *BRITISH BANKING, 1960–85*, at 139–94 (1986); M. REID, *THE SECONDARY BANKING CRISIS, 1973–75*, at 116–19 (1982); *Banking Crises and Risks*, in UK BANKING SUPERVISION 3 (E. Gardener ed. 1986) [hereinafter *Banking Crises and Risks*]; Metcalfe, *Self-regulation, Crisis Management and Preventive Medicine: The Evolution of UK Bank Supervision*, in UK BANKING SUPERVISION 126 (E. Gardener ed. 1986); Reid, *Lessons for Bank Supervision from the Secondary-Banking Crises*, in UK BANKING SUPERVISION 99 (E. Gardener ed. 1986).

it is unrealistic to expect bank managements and capital owners to shoulder *the entire* burden. The Federal Reserve (lender-of-last-resort credit) and various net capital assistance programs (through long-term loans) instituted in order to recapitalize troubled or failing institutions are the logical avenues through which the government can relieve "systemic" adversities. In this way, "systemic risks" are covered partly by government.<sup>47</sup> Why? Because the failure to alleviate "systemic" financial breakdowns would otherwise weaken general economic prosperity, disrupt the flow of investments and credits, and needlessly burden societies that depend upon healthy banks and financial institutions.

But among bank leaders, equity stockholders and other risk capital security holders, large depositors, and small depositors, who is best prepared to bear the loss of bank failures? In other words, what is the best private loss-allocation or apportionment formula for the problems of bank failure?

Certainly bank leaders and stockholders or other risk-capital security holders are properly liable for managerial risks when managerial shortcomings are the main reasons for such bank failures.<sup>48</sup> But what about "systemic" risks? To what extent should bank managers and capital owners be held responsible for "systemic risks," such as malfunctioning world markets, or mismanaged macroeconomic policy? Further, who, if anyone, is *truly responsible* for national macroeconomic policies or the world marketplace? The best solution is to enforce substantial bank capital requirements (including the new G-12 risk-based capital requirements) to provide a first reserve against failure and losses by banks and other depository institutions. Yet, when banks fail mainly because of "systemic risks," the Federal Reserve and FDIC (or FSLIC) should be generous with recapitalization credits to revive these banks or financial institutions.<sup>49</sup>

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47. See G. BENSTON, *supra* note 1, at 109-26; W. LOVETT, *BANKING*, *supra* note 1, at 51-68, 248-56, 271-76; I. SPRAGUE, *supra* note 1, at 231-64; see also R. DALE, *supra* note 1, at 207 (references to Lender-of-Last-Resort in Index); J. GRADY & M. WEALE, *supra* note 46, at 149-94; M. REID, *supra* note 46, at 116-19; P. STUDENSKI & H. KROOS, *supra* note 1, at 353-458; *Banking Crises and Risks*, *supra* note 46, at 3; Metcalfe, *supra* note 46, at 126; Reid, *supra* note 46, at 99. In the midst of widespread banking and institutional failures, a strong policy of extensive emergency credits, recapitalization, and rescue-salvage operations puts a premium on general results and promptness rather than extreme tidiness or exactitude of proportional relief. This important lesson is illustrated by the U.S. Great Depression experience, the British secondary banking crisis of 1973-77, and the widespread failures of U.S. thrifts and agricultural and oil-patch banks in the 1980s. See, e.g., M. REID, *supra* note 46, at 116-19; Reid, *supra* note 46, at 99; see also R. BRUMBAUGH, *supra* note 10, at 141-44; Nash, *Squeeze on U.S. Agency Seen as Result of Savings Rescues*, N.Y. Times, Sept. 7, 1988, at 1, col. 1.

48. See I. SPRAGUE, *supra* note 1, at 231-64; see also G. BENSTON, *supra* note 1, at 1-108, 235-38. As Benston and others observed: "Empirical evidence shows that large claims on deposit-insurance reserves have resulted mainly from two sources: managerial fraud; and desperately risky endgame plays made by client banks that were allowed to remain in operation long after they became economically insolvent." G. BENSTON, *supra* note 1, at 236. Thus, the renewed consensus and increasingly dominant view among banking experts is that reasonable prudential requirements, including adequate capital and limited risk-related deposit insurance premiums, should be combined with adequate continuing supervision—so that when banks or similar institutions approach insolvency, they must be promptly closed, with their assets and deposit liabilities transferred to sound institutions. As Paul M. Horvitz put it: "If insured institutions are closed before their net worth is totally depleted, losses to the insurance system are small, regardless of the riskiness of individual institutions." Horvitz, *The Case Against Risk-Related Deposit Insurance Premiums*, in *UK BANKING SUPERVISION* 270 (E. Gardener ed. 1986). For a good summary of established officer-director liabilities in financial institutions, see I. M. MALLOY, *supra* note 1, at §§ 3.2.6-3.4.

49. Responsible, vigorous financial institution regulation policy is really all that Congress and the public expect. See G. BENSTON, *supra* note 1, at 109-26; W. LOVETT, *BANKING*, *supra* note 1, at 122-28; I. SPRAGUE, *supra* note 1, at



It seems unfair and totally unrealistic, however, to saddle the small depositors with any risk of loss for bank failure, either for "managerial" weakness or "systemic" breakdowns. Saddling small depositors with the risk of bank failure would merely threaten consumer purchasing power, aggregate employment, and general prosperity, and impose a burden of inquiry upon innocent families least likely to understand or know of risks to their bank deposits. Such a policy would merely restore the pre-FDIC incentives for widespread runs by citizens on banks. There is a well-established consensus that small depositors should be protected from bank failure. Due to this belief, post-Depression FDIC deposit insurance is sound congressional policy.<sup>50</sup>

While a few experts urge partial loss exposure for large depositors, "systemic" and "managerial" risks are very hard to estimate. Reliable information on possible bank failure is hard to develop, even for bank regulators, and tends to be closely held in troubled institutions. Making larger depositors pay substantial losses for bank failures merely would force costly and unreliable depositor inquiries and make financial institutions much more vulnerable to rumors, large depositor runs, or malicious gossip (spread even by rival banks). Large depositors under a new loss exposure discipline would hold themselves poised to withdraw their deposits from insecure banking institutions and restore pre-FDIC vulnerability to banks and financial institutions.<sup>51</sup>

In fact, no major banking country that seeks substantial international deposits in the world today could afford to let one of its major banks fail. If it would, its capital markets would become unreliable to foreign banks, MNCs, and other large depositors.<sup>52</sup> This is why U.S. bank regulators simply had to bail out U.S. National Bank of San Diego in 1971, Franklin National in 1974, First Philadelphia in 1981, Continental Illinois in 1983, and First Republic Bank of Texas in 1988.<sup>53</sup> All

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231-64; see also R. BRUMBAUGH, *supra* note 10, at 141-44; R. DALE, *supra* note 1, at 207 (references to Lender-of-Last-Resort in Index); J. GRADY & M. WEALE, *supra* note 46, at 175-94; M. REID, *supra* note 46, at 116-19; P. STUDENSKI & H. KROOS, *supra* note 1, at 353-458; *Banking Crises and Risks*, *supra* note 46, at 3; Metcalfe, *supra* note 46, at 126; Reid, *supra* note 46, at 99; Nash, *supra* note 47, at 1, col. 1.

50. See, e.g., G. BENSTON, *supra* note 1, at 81-82; R. DALE, *supra* note 1, at 64-66; J. GALBRAITH, *supra* note 1, at 134-382; C. GOLEMBE & D. HOLLAND, *supra* note 1, at 109-28; C. HENNING, *supra* note 1, at 90-100; D. KIDWELL & R. PETERSON, *supra* note 1, at 215-18, 415-20; N. LASH, *supra* note 1, at 22-23; W. LOVETT, BANKING, *supra* note 1, at 55-56; I. M. MALLOY, *supra* note 1, at § 1.3.3; T. MAYER, *supra* note 1, at 22-24; M. MYERS, *supra* note 1, at 319-21; I. SPRAGUE, *supra* note 1, at 17-19; see generally J. WELCH, *supra* note 1; UK BANKING SUPERVISION, *supra* note 1.

51. This lesson has been "relearned" by bank regulators in the early 1980s. See G. BENSTON, *supra* note 1, at 13-15; R. DALE, *supra* note 1, at 64-66; I. SPRAGUE, *supra* note 1, at 242-64; *Supervisory Issues*, *supra* note 45, at 46.

52. This is the international logic of the Basle Concordats I and II, the main principles of international banking regulation. See R. DALE, *supra* note 1, at 172-94; M. MENDELSON, *supra* note 4, at 40-51.

53. For a nearly complete listing of larger bank failures in the U.S. through December 31, 1985, see I. SPRAGUE, *supra* note 1, at 109-228. For more recent developments, see R. BRUMBAUGH, *supra* note 10, at 30-36; J. FAUX, *supra* note 31, at 1; INSTITUTE FOR INTERNATIONAL ECONOMICS, *supra* note 31, at 1; W. LOVETT, BANKING, *supra* note 1, at 122-23; W. LOVETT, INFLATION, *supra* note 27, at 185-207; W. LOVETT, TRADE, *supra* note 29, at 157-58; I. SPRAGUE, *supra* note 1, at 252-64; Bergsten, *supra* note 31, at 770; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; *Congress Will Provide*, *supra* note 8, at 307; *FDIC Has Become*, *supra* note 8, at 252; *Financial Condition*, *supra* note 8, at 168; Gorman, Hornik & Woodbury, *supra* note 8, at 54; Packard, *supra* note 30, at 348; Rapp, *Deficit Limits*, *supra* note 32, at 327; Rapp, *House Panel*, *supra* note 32, at 726; Rapp, *OMB Fiscal*, *supra* note 32, at 2089; Reich, *supra* note 31, at 516; Rodriguez, *supra* note 42, at 129; *Senate Adopts Resolution*, *supra* note 8, at 204; Van

depositors, large as well as small, were fully protected in these large bank failures. Although Penn Square Bank, a mere \$200 million local bank, was allowed to fail in 1982 and caused loss to large depositors with accounts greater than the current federal deposit insurance limit of \$100 thousand as a lesson to larger depositors, this disciplinary experiment has been infrequently repeated.<sup>54</sup> For a good and proper reason too! If any significant number of large depositors suffered loss in other U.S. bank failures, the credibility of U.S. institutions as reliable havens for international and domestic business deposits would be impaired.

Therefore, the only sensible U.S. policy is to require that the main risk of loss for bank failures continue to fall upon the equity shareholders and related purchasers of preferred stock, debentures, or notes who accept equity or loss risks.<sup>55</sup> Of course, these public stockholders or other risk-capital security holders should sue the top bank officers and/or directors for any breach of fiduciary duties. More extensive asset data filings, pledged collateral, or other remedies should be used to strengthen shareholder relief against bank leaders liable for poorly managed financial institutions. For example, fraudulent bank officers should not be allowed to "stash" their money in Swiss banks or other international havens. But the basic burden of proof for breach of managerial duty must lie with bank stockholders, or the FDIC, FSLIC, or NCUSIF acting as receivers for bankrupt or failed institutions.<sup>56</sup>

#### A. *Implementing Risk-Based Capital Requirements*

In the fall of 1987 Central Bank representatives from the G-12 countries (U.S., Canada, Japan, United Kingdom, W. Germany, France, Italy, Netherlands, Belgium, Luxembourg, Switzerland, and Sweden) reached provisional agreement on a new minimum standard for risk-based capital requirements. This arrangement was formalized in July 1988 with a few additional compromises allowing individual countries a little more latitude. The Basle G-12 standard strengthens capital and reserves for most of the significant multinational banking institutions in the world and establishes a more uniform playing field for the banking industry among the OECD nations.<sup>57</sup> The basic requirement is eight percent capital for "total risk assets" in bank balance sheets. At least one half of this capital must be "core capital" (Tier 1),

Wolferen, *supra* note 30, at 288; Volcker, *supra* note 32, at 31; Walsh, *supra* note 32, at 1; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1; Nash, *supra* note 47, at 1, col. 1; Noble, *supra* note 39, at A-12, col. 1.

54. See R. BRUMBAUGH, *supra* note 10, at 49-56; W. LOVETT, *BANKING*, *supra* note 1, at 122-28; I. SPRAGUE, *supra* note 1, at 242-48; Bock, Hornik & Svoboda, *supra* note 8, at 60; Caliguire & Thomson, *supra* note 8, at 1; *FDIC Has Become*, *supra* note 8, at 252; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1; Nash, *supra* note 47, at 1, col. 1.

55. These are the general conclusions of most banking regulatory experts today. See G. BENSTON, *supra* note 1, at 175-79; I. SPRAGUE, *supra* note 1, at 242-66; Flannery, *Deposit Insurance Creates a Need for Bank Regulation*, in *UK BANKING SUPERVISION 258* (E. Gardener ed. 1986). Some even suggest, perhaps, that double liability might be restored for bank stockholders in some form. See G. BENSTON, *supra* note 1, at 176.

56. See M. MALLOY, *supra* note 1, at §§ 3.2.4-3.4.

57. See *Basle Risk-Based Capital Standards*, *supra* note 11, at 143 (full text of Basle G-12 standards); *Fed Staff Summary*, *supra* note 11, at 232 (Federal Reserve's implementation of Basle standards). For background on Basle standards, see, e.g., *Basle Committee*, *supra* note 11, at 135; *Central Bankers*, *supra* note 11, at 101; *Fed May Let*, *supra* note 11, at 79; Malloy, *supra* note 11, at 75. For background on Fed implementation of the Basle standards, see, e.g., *Fed Adopts Risk-Based*, *supra* note 11, at 201. For general background on risk-based capital standards, see, e.g., Bardos, *supra* note 11, at 26; Keeley, *supra* note 11, at 1.

and no more than half may be "supplementary capital" (Tier 2). Low risk assets need less capital, however, so that many banks might only require six to seven percent overall capital on total assets, which is already typical for sound U.S. banking institutions. This new eight percent standard is to be achieved by the end of 1992, and a preliminary goal of 7.25 percent capital for total risks is set for 1990 as a transition target.<sup>58</sup>

Capital is defined rather liberally so that most sound banks in the U.S. and elsewhere can qualify without great difficulty.<sup>59</sup> "Core capital" (Tier 1) includes common stock equity and retained earnings, along with noncumulative preferred stock. However, "good will" should not be considered "core capital." "Supplementary capital" (Tier 2) includes hybrid (debt/equity) capital securities, subordinated capital debt, and general loan loss reserves or provisioning, all of which are applicable to U.S. banks, together with "asset revaluation reserves" and "undisclosed reserves" (hidden retained earnings). (Undisclosed reserves (or hidden retained earnings) or asset revaluation reserves can be sizeable in other national banking systems, especially where major long term economic growth yielded very generous appreciation for some securities and other assets in bank portfolios, *e.g.*, Japan during the last 40 years.) But supplementary capital will be further limited at the end of 1992 in that: (a) Subordinated debt elements should not exceed fifty percent of Tier 1 capital or two percent of total risk assets; and (b) General loan loss reserves should not exceed 1.25 percent of total risk assets or two percent of total risk assets (in other than exceptional and temporary circumstances).

A key to understanding the new risk-based capital requirements are reduced risk weights for lower risk assets in the bank's asset portfolio.<sup>60</sup> Most important are zero and twenty percent risk weight categories because banking institutions holding more of these assets can reduce their effective capital requirements appreciably.

### 1. Zero Risk Assets

Cash, securities, and obligations of central governments and central banks denominated in their own currencies, and securities guaranteed by OECD central governments require no capital because the G-12 agreement determines they have zero risk.<sup>61</sup> This means, for example, that U.S. government T-bills and bonds (but not state or municipal bonds) are zero risk, along with Federal Reserve, FDIC, and FSLIC securities issued to recapitalize troubled bank and thrift institutions. This arrangement supports a steady market for U.S. and other OECD nation government

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58. *Basle Risk-Based Capital Standards*, *supra* note 11, at 144 (section I) (Basle G-12 standards text).

59. *Basle Risk-Based Capital Standards*, *supra* note 11, at 144-46 (section I). But the U.S. implementation is more liberal in that perpetual cumulative preferred stock may also qualify as Tier 1 core capital. *See Fed Staff Summary*, *supra* note 11, at 232-33; *see also Fed Adopts Risk Based*, *supra* note 11, at 201. This is a major relief to large U.S. multinational banks with reduced common stock equity capital and eases their access to more marketable capital securities. *See supra* note 11 and accompanying text. Subordinated debt is also more readily marketable and serves the capital risk function well. *See G. BENSTON*, *supra* note 1, at 179. However, subordinated debt comes under the Tier 2 or "supplementary capital" classification under the Basle standards.

60. *Basle Risk-Based Capital Standards*, *supra* note 11, at 146-48, 152-55 (section II and annexes 2 and 3).

61. *Id.* at 147-48, 152.

debt securities. In many nations, of course, banks have taken their own government's debt for much larger shares of their bank asset portfolios, as many U.S. banks did during World War II and soon thereafter.

## 2. Twenty Percent Risk Assets

Securities and obligations of multilateral development banks (International Bank for Reconstruction & Development (World Bank), Inter-American Development Bank, Asian Development Bank, African Development Bank, European Investment Bank), obligations of banks incorporated in OECD countries, obligations with maturities up to one year from banks in non-OECD countries, obligations of nondomestic public sector entities from OECD countries, and cash items in process of collection carry twenty percent risk weights.<sup>62</sup> This allows easier refinancing and longer rescheduling of LDC debt overloads, fosters international trade finance, and does not threaten the widespread network of interbank deposits and lending among multinational banking institutions throughout the world today. These provisions can be interpreted as constructively conservative, *i.e.*, strengthening the already substantial growth of global finance, investment, and trade, especially by encouraging lending diversification and enlarged credits for rescheduling LDC debt obligations.

## 3. Zero, Ten, Twenty, or Fifty Percent (At National Discretion) Risk Assets

Obligations of domestic public sector entities, excluding central governments (*e.g.*, U.S., state, or municipal bonds; foreign, provincial, or local government obligations; and quasi-government companies in the U.S. or abroad) receive risk treatment according to each G-12 country's national policies.<sup>63</sup> This reflects the diversity in loan quality of these noncentral governmental obligations and the lack of consensus for capital requirements in this area. Below normal risk weights for obligations of domestic public sector entities, however, will facilitate rescheduling for a substantial portion of existing LDC debt overloads. Further, to the extent LDC governments guarantee repayment on shorter-term obligations of their public sector entities up to one year, twenty percent low risk weights can be assured generally among G-12 creditor banks.<sup>64</sup>

## 4. Fifty Percent Risk Assets

Loans fully secured by mortgages on residential property, which are owner occupied or rented, carry fifty percent risk weights, provided that realistic market appraisals support these collateral values.<sup>65</sup> In most G-12 countries with high

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62. *Id.* at 148, 152.

63. *Id.*

64. The 20% risk weight provision encourages more current, responsible, and reliable rescheduling of LDC debt overloads and allows multinational creditor banks to achieve substantially lower capital cover for loans that can be rescheduled into this one year or less category.

65. *Basle Risk-Based Capital Standards*, *supra* note 11, at 148, 153 (section II & annex 2); *Fed Staff Summary*, *supra* note 11, at 235.

population densities and secure real estate, this special treatment of real estate financing seems reasonable. During the post-World War II era, somewhat reduced capital requirements were logical for U.S. thrifts (S & Ls and savings banks). But thrifts suffered an earnings-capital squeeze with high inflation from 1979 to 1981, and at least 500 thrifts suffered a secondary squeeze in the mid to late 1980s with excessive real estate speculation after partial deregulation, especially in Texas and oil-patch areas. In present circumstances, when many U.S. thrifts need major recapitalization, lowering capital requirements for real estate financing could be controversial and might encourage more banks to offer substantial real estate lending. But the Fed recommends implementing the fifty percent risk weight for real estate lending, provided it is limited to first mortgages on one to four family residential properties, loans do not exceed eighty percent of appraisal values, and loans are not past due or nonperforming. The fifty percent risk weight will not apply to loans for speculative property development or construction.<sup>66</sup>

### 5. One Hundred Percent Risk Assets

Normal or full risk applies to all other obligations of private sector enterprises, including obligations of non-OECD banks that have maturities of more than one year, obligations of governments outside the OECD (unless denominated in a hard currency and funded in that currency), obligations of commercial companies owned by the public sector, nonresidential real estate, capital instruments issued by other banks, and all other assets.<sup>67</sup> Except for the previously listed lower risk assets, the G-12 minimum capital requirements will be eight percent at the end of 1992 on these normal risk assets or investments by banks and thrift institutions. Of special interest is an encouragement for non-OECD countries to denominate some of their external debts in hard currency and fund that portion in hard currencies to achieve low risk weight status for participating multinational banks.<sup>68</sup>

### 6. Off-Balance-Sheet Items

Most direct credit substitutes, *e.g.*, general guarantees including standby letters of credit serving as financial guarantees for loans and securities, and acceptances, including endorsements with the character of acceptances, receive normal or one hundred percent risk weights.<sup>69</sup> Eight percent capital should be maintained against these transactional obligations by the end of 1992. However, limited exceptions of only fifty percent risk weight apply to: (i) Certain transaction-related contingent items (*e.g.*, performance bonds, bid bonds, warranties, and standby letters of credit related to particular transactions); (ii) Note issuance facilities and revolving underwriting

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66. *Basle Risk-Based Capital Standards*, *supra* note 11, at 148, 153 (section II & annex 2); *Fed Staff Summary*, *supra* note 11, at 235. The 50% risk weight for residential real estate financing, collateralized with secure mortgage interests, greatly facilitates recapitalization of U.S. thrift institutions and assures adequate real estate financing. It also encourages banks, to the extent their powers provide for residential real estate lending, to participate in this market.

67. *Basle Risk-Based Capital Standards*, *supra* note 11, at 149, 153 (section II & annex 2).

68. *Id.* at 147-48, 152.

69. *Id.* at 149, 153.

facilities; and (iii) Other commitments with an original maturity exceeding one year. Shorter term commitments or commitments that can be unconditionally cancelled at any time are agreed to carry only low risk and a nil weight is justified on de minimus grounds.<sup>70</sup> A risk weight of only twenty percent applies to short-term, self-liquidating, trade-related contingent liabilities arising from the movement of goods, such as documentary credits collateralized by the underlying shipments.<sup>71</sup> This means that many off-balance sheet activities for banks must have eight percent capital by the end of 1992 for their asset or liability potential, except that lower risk weights apply to certain banking transactions traditionally carrying low risk exposure for banks. Whether these lower risk weight exceptions might invite broader or excessive use by banks will depend upon bank practices and the supervision process for bank regulators following the G-12 agreement.

#### B. *Problems of Potential Diversification*

To the extent banking institutions are allowed to diversify outside fields traditionally employed by banks for lending, trade finance, risk guarantees, and secure liquid investments, there is an obvious problem of risk weights. The Basle G-12 agreements of 1987 to 1988 provide partial guidance, such as assigning low risk weights for activities that have below normal banking risks. Thus, for fully collateralized activities such as trade finance supported by documents of credit for shipment or storage, twenty percent risk weights are acceptable.<sup>72</sup> But it seems doubtful that much bank diversification could attain such strong levels of collateralization or relative security. The major short-term target for diversification by many large banks is the securities industry, which divides mainly into: (i) Underwriting and the wholesale marketing of securities, and (ii) Retail brokerage or distribution of securities to investor families and the management of customer accounts. With respect to underwriting, the G-12 agreements allow fifty percent risk weights for note issuance and revolving underwriting facilities, or capital requirements of only four percent of total assets involved in these activities.<sup>73</sup> Whether this brief, preliminary statement in the off-balance-sheet list of risk weights could be the final guideline for all securities activities by banks, bank holding companies, and other financial institutions, is doubtful. No other G-12 provision applies directly to securities marketing, mutual funds sales, or other securities activities, except the normal one hundred percent risk weight or eight percent capital requirements for all other assets, the ultimate residual category in the G-12 agreement.

In contrast, under current SEC net capital rules (SEA rule 15c3-1), most

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70. *Id.* at 153.

71. *Id.*

72. See *supra* note 62 and accompanying text.

73. *Basle Risk-Based Capital Standards*, *supra* note 11, at 153 (annex 3). But the Fed's implementation, *Fed Staff Summary*, *supra* note 11, at 234, allows unconsolidated bank holding company securities subsidiaries to be excluded from the bank holding company's capital base and capital requirements. This suggests a Fed intention to let the SEC define capital requirements for such securities subsidiaries, although a vague provision indicates the Fed also intends some oversight on "strong firewalls, adequate non-bank capital, and other provisions the Board deems necessary. . . ." *Id.* at 233.

broker-dealers in securities within the U.S. must maintain net capital (or net worth) of at least \$25,000 and they should not let their aggregate indebtedness (total obligations) exceed 1500 percent of their net capital.<sup>74</sup> This amounts to a six and two-thirds percent capital requirement on aggregate indebtedness. Presumably, this covers obligations to customers for retail brokerage networks. Complex adjustments for different circumstances can be made under this regulation, which tries to take into account the downside risks in market value of various securities. Alternatively, broker-dealers can qualify under rule 15c3-1F, which merely requires net capital to be equal to the greater of \$100,000 or two percent of the aggregate debit balances attributable to transactions with customers. Most big underwriters and major retail brokerage chains employ the latter, simpler, and less demanding capital requirement formula.

Most big U.S. banks and bank holding companies would set up securities affiliates if allowed by repeal or modification of the Glass-Steagall Act and would want to qualify for less demanding capital requirements under the SEC rules. The Fed's proposed version of the G-12 guidelines would exempt bank holding companies' securities affiliates from the Basle agreement's capital requirements. This would allow much higher leverage, especially under rule 15c3-1F, for large bank holding company affiliates than for smaller bank holding companies or independent banks. This competitive inequality should be eliminated. But what is the best compromise between the Basle G-12 requirements: four percent capital requirements for note underwriting and eight percent for other bank assets or obligations, and SEC rule 15c3 with a capital requirement of six and two-thirds percent of aggregate indebtedness for most smaller broker-dealers; or two percent of aggregate debit balances attributable to transactions with customers for the largest securities firms and underwriters?<sup>75</sup>

This legal disharmony is illogical and discriminates in favor of the largest bank holding companies and securities firms. More careful inquiry on this issue by G-12 central banks, securities regulators, and national legislators, including the U.S. Congress, seems appropriate before any major broadening of securities powers (such as repeal or modification of Glass-Steagall) is enacted by the U.S. Congress. The Independent Bankers Association of America (IBAA), representing half of this country's banks, has taken a strong stand against unequal access among banks to securities marketing opportunities.<sup>76</sup> For example, mutual funds could easily be sold

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74. SEC Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1 (1988); see Haberman, *Capital Requirements of Commercial and Investment Banks: Contrasts in Regulation*, Q. REV. (Fed. Reserve Bank of New York), Autumn 1987, at 1 (good explanatory article); see also Pozdena, *Leverage and Double Leverage in Banking*, FRBSF WEEKLY LETTER (Fed. Reserve Bank of San Francisco), June 20, 1986, at 1.

75. If major U.S. bank holding companies could shift major portions of their lending activities into the format of securitizing commercial paper through a securities affiliate, important reductions in effective capital requirements could be achieved, say from eight percent on full risk assets such as normal commercial loans to only two percent on assets in a rule 15c3-1F securities affiliate. This loophole could be used to emasculate an important part of the new Basle G-12 risk based capital standards.

76. See *Reform Hearings*, *supra* note 13, at 90-139 (part 2) (testimony of Charles T. Doyle). Lovett, in his House testimony, also suggested that independent and community banks might need exemptions from bank holding company

through small banks in small towns, suburbs, and local neighborhoods. Thrift institutions, including savings banks and S & Ls, if soundly capitalized to the normal level of banks, could also seek equal access to securities marketing opportunities. Although underwriting activities are more likely to be carried on by the largest banks or bank holding companies (except for local municipal bonds and commercial paper from medium-sized companies), a great discrepancy in capital requirements does not seem justified between differently sized banking institutions.

Bank diversification into the marketing and underwriting of insurance presents greater potential complications than the securities field. Banks and bank holding companies generally have been separated from insurance companies, insurance underwriting, and most insurance distribution markets by long established custom and regulatory tradition. The only significant overlap thus far has been the small town bank holding company exceptions, which allow joint ownership of local banks, insurance agencies, and realty firms.<sup>77</sup> If banks, bank holding companies, or other depository institutions were allowed generally to acquire or merge with insurance companies, significant problems of harmonizing regulatory standards for capital adequacy, chartering, licensing, reserves, supervision, and accountability for both bank and insurance company regulation would be presented.<sup>78</sup>

While insurance policies could be retailed easily enough by existing depository institutions with little danger to the public, possibly providing some benefit, this would be quite disruptive to the existing distribution network for insurance.<sup>79</sup> Direct writer sales forces and independent insurance agencies would be significantly damaged. Already many of these insurance interests have complained strongly against bank holding companies being allowed to market or underwrite insurance, which led to the passage of the Dodd Amendment in 1984 by a large majority in the Senate. There is no indication that this resistance has weakened appreciably since that time.

Ideally, the door for financial service holding companies to enter into the insurance underwriting and related pension plan field should not be opened until a better framework of federal standards for insurance capital, reserves, rates, and supervision is set up. Frankly, at this stage, neither the SEC nor the "bank" regulatory agencies (Federal Reserve, OCC, FDIC, FHLBB (Federal Home Loan

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restrictions to participate fairly and equally in marketing mutual funds, municipal and revenue bonds, and other securities to their customers. *See Id.* at 201, 221 (part 3).

77. *See* W. LOVETT, *BANKING*, *supra* note 1, at 183; J. WHITE, *supra* note 16, at 395-97.

78. *See Reform Hearings*, *supra* note 13, at 1-86 (part 3), 96-124, 199-234; *see also* K. BLACK & H. SKIPPER, *supra* note 15, at 568-83; M. DOREMAN, *supra* note 15, at 410-30; G. REJDA, *supra* note 15, at 581-98; A. TOBIAS, *supra* note 15, at 269-78.

79. For concerns of the Alliance for the Separation of Banking and Insurance (comprising Independent Insurance Agents of America, National Association of Casualty and Surety Agents, National Association of Insurance Brokers, National Association of Life Underwriters, National Association of Professional Insurance Agents, and National Association of Surety Bond Producers), *see Reform Hearings*, *supra* note 13, at 96-109 (part 3) (testimony of William V. Irons). For concerns of the American Council of Life Insurance, *see Reform Hearings*, *supra* note 13, at 110-24 (part 3) (testimony of Warren R. Wise). All of these insurance trade associations strongly oppose dismantling the Glass-Steagall and other legal boundaries between banking and insurance.



Bank Board), or FSLIC) are currently competent to handle comprehensive insurance regulation.<sup>80</sup>

Conglomerate financial service holding companies, if allowed to proliferate quickly and without careful supervision, could become vehicles for extensive corporate raiding, looting, and breach of fiduciary duties in the insurance company and pension plan field.<sup>81</sup> There is a serious risk of misadventure due to the wide-open

80. Almost all insurance regulation in the U.S. is now carried on at the state level of government through their commissions or departments of insurance. For an introduction, see, e.g., W. LOVETT, *BANKING*, *supra* note 1, at 338-79. For more detailed information on insurance regulation, see, e.g., K. BLACK & H. SKIPPER, *supra* note 15, at 568-83; M. DORFMAN, *supra* note 15, at 410-30; G. REJDA, *supra* note 15, at 581-98; A. TOBIAS, *supra* note 15, at 269-78.

81. The insurance and pension industry markets comprise much larger aggregate sales, revenues, capital, and assets than securities brokers or underwriters. See tables in W. LOVETT, *BANKING*, *supra* note 1, at 300, 343, 381, 414, 437. See also *Reform Hearings*, *supra* note 13, at 1-86 (part 3), 96-124, 199-234. Hence, the potential profits and bureaucratic gains for large bank holding companies or large securities firms are substantially greater in the insurance and pension industries than for simply allowing large bank holding companies and securities firms into each other's markets, or permitting large bank holding company-securities firm mergers.

The potential for corporate looting, raiding, takeovers, and breach of fiduciary duties should never be underestimated. Whenever financial supervision is weak, abuses can be expected to grow. Certainly the Texas thrift industry in the early mid-1980s illustrates the potential for widespread fraud, and even looting, when serious supervision lapsed and speculative mania became fashionable. See R. BRUMBAUGH, *supra* note 10, at 59, 69; see also *Fraud and Abuse by Insiders, Borrowers, and Appraisers in the California Thrift Industry: Hearing Before a Subcomm. of the House Comm. on Government Operations*, 100th Cong., 1st Sess. (1987) [hereinafter *Fraud Hearings*]; Bock, Beaty & Woodbury, *How to Rob Banks Without a Gun*, *TIME*, Aug. 15, 1988, at 30.

Corporate takeover activity and raiding have become more fashionable, even though they arouse substantial concern. See, e.g., *Hostile Takeovers: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. (1987); ECONOMICS DIVISION OF THE CONGRESSIONAL RESEARCH SERVICE, 100TH CONG., 1ST SESS., *REPORT ON LEVERAGED BUYOUTS AND THE POT OF GOLD: TRENDS, PUBLIC POLICY, AND CASE STUDIES* (Comm. Print 1987); J. BROOKS, *THE TAKEOVER GAME* 1-33 (1987); A. MICHEL & I. SHAKED, *TAKEOVER MADNESS* (1986); Greenwald & Ungeheuer, *High Times for T. Boone Pickens*, *TIME*, Mar. 4, 1985, at 52; Greenwald & Ungeheuer, *Let's Make a Deal*, *TIME*, Dec. 23, 1985, at 42; Jonas, Berger & Pennar, *Do All These Deals Help or Hurt the U.S. Economy?*, *BUS. WEEK*, Nov. 24, 1986, at 86; Nussbaum, *Deal Mania: The Restructuring of Corporate America*, *BUS. WEEK*, Nov. 24, 1986, at 74; *The Toll of a 'Nonstop Binge' Five Respected Leaders Assess the Damage*, *NEWSWEEK*, Nov. 2, 1987, at 49. In an overall assessment of the doubtful, often negative contribution of merger-takeover activity to the economy, David Ravenscraft, a leading analyst, commented: "Energy, money, and time have been wasted on the merger game that would have been better spent rebuilding America's industrial base." *The Takeover Controversy: Shareholders v. Managers*, 7 CATO POL'Y REP. 6, 9 (1986).

Unfortunately, antitrust relaxation in the Reagan era allows much larger concentration in financial markets to proceed more rapidly. See *Reform Hearings*, *supra* note 13, at 50-86 (part 3), 254-72 (testimony of Bernard Shull); Adams & Brock, *Mr. Reagan and Antitrust*, in *PUBLIC POLICY TOWARD CORPORATIONS* 3 (A. Heggestad ed. 1988); Lovett, *Antitrust in the Current Economic Environment*, in *PUBLIC POLICY TOWARD CORPORATIONS* 17 (A. Heggestad ed. 1988); Mueller, *The New Attack on Antitrust*, in *PUBLIC POLICY TOWARD CORPORATIONS* 53 (A. Heggestad ed. 1988). But "conglomerate power is not an optical illusion. It is a matter of public concern and a challenge for public policy. . . . [It] can lessen competition, and tend to create monopoly by mobilizing such weapons as cross-subsidization, reciprocal dealing, and competitive forbearance." W. ADAMS & J. BROCK, *THE BIGNESS COMPLEX* 192 (1986).

The potential for a major restructuring and more highly concentrated U.S. financial system is real. There were influential advocates of such change in high places in the late Reagan administration. See Guttman, *Changing of the Guard at the Fed*, *CHALLENGE*, Nov.-Dec. 1987, at 4; Nash, *Treasury Now Favors Creation of Huge Banks*, *N.Y. Times*, June 7, 1987, at 1, col. 1. Other nations show the recent potential for major consolidation within financial industries if regulators allow this to happen. In Canada, after major new deregulation, five of the seven largest securities brokers announced plans to sell large ownership interests to large banks. See *Reform Hearing*, *supra* note 13, at 92 (part 2) (testimony of Charles T. Doyle). In Britain, bear in mind the drastic consolidation of banking that came with no limits on mergers. Michael Moran summarized British developments as follows:

In the mid-nineteenth century branch banking was highly competitive: new entrants to the industry were common, banks competed over the rates offered to depositors and borrowers, and there was rivalry over such services as hours of opening. The amalgamations before the First World War produced a loose and unstable cartel fixing interest rates for depositors. The emergence of the Big Five in 1918 made this cartel totally effective, and over the next two decades killed almost every kind of visible competition in retail banking.

M. MORAN, *THE POLITICS OF BANKING* 15 (2d ed. 1986); see also, M. CLARKE, *REGULATING THE CITY* 1-20 (1986)

access to merger and takeover games in this area. Minimal accountability and modest regulation in this area would pose serious trouble and invite irresponsibility. Questionable assets such as junk bonds, low-grade commercial paper, shares in third-world debt, and the like could easily be dumped into fiduciary portfolios like insurance reserves, pension funds, and trust account assets managed by financial service conglomerates.<sup>82</sup> Even though an outbreak of scandals and failing insurance companies or pension plans might bring later corrective regulation, it would be wiser to proceed cautiously and limit disruptions.

A serious difficulty is the lack of federal regulation and accumulated expertise for the insurance industry. Unlike the Federal Reserve, FDIC, OCC, and SEC, which enjoy more than fifty years of extensive and talented staffing, a network of well-trained alumni, and side academic support in university economics and finance departments, and colleges of law, comparable professionalism for insurance regulation is much more limited. Most insurance industry regulatory expertise exists among the larger companies, relatively few academic departments of insurance, and very small staffs in state insurance commissions. Certainly the SEC could be relied upon to represent responsibly the interests of securities underwriters and the broker-dealer network (National Association of Securities Dealers) in the event of major weakening or repeal in the Glass-Steagall boundaries, or to supervise bank holding companies that are allowed to establish securities affiliates. But there is no adequate counterpart to the SEC for the insurance industry. While insurance trade associations can lobby with reasonable skill, that is no substitute for a comprehensive tradition of federal regulatory expertise, Congressional committee staffs, economic studies, and sophisticated wisdom about practices and problems of the insurance industry.<sup>83</sup>

To what extent are integrated financial conglomerates necessary or desirable for insurance? Limited experimentation along these lines, carefully supervised to maintain capital adequacy, reserves, soundness, and fiduciary responsibility might seem to involve modest risks. But when mergers, takeovers, and displacement become popular and widespread, financial markets become more concentrated, more difficult to enter, and the survival of independent and smaller institutions is threatened. Further, the scrambling together of banking, securities, insurance, and pension funds will be a dubious achievement. Significant excesses, questionable transactions, and even looting of funds and reserves can occur easily if complete

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(background on the "clubby" traditions of financial regulation in Britain); J. GRADY & M. WEALE, *supra* note 46, at 166-67.

82. For concern about the problems of overleveraging and rapid debt growth, along with the proliferation of junk bonds, see H. KAUFMAN, *supra* note 35, at 34-36; see also Greenwald & Ungeheuer, "Today Things Are Getting Out of Hand," *TIME*, Dec. 23, 1985, at 51; *Of Turf Wars and Junk Bonds*, *FORTUNE*, Jan. 20, 1986, at 8; Sloan, *Red Faces at Morgan Stanley*, *FORBES*, July 29, 1985, at 43; *Taking Out the Garbage*, *MONEY*, Jan. 1986, at 13. For discussion of the inherent difficulty of supervising firewalls between financial institutions, see, e.g., *Reform Hearings*, *supra* note 13, at 45-86 (part 3), 235-53 (testimony of Roy A. Schotland).

83. Far more congressional wisdom, regulatory expertise, and talent has accumulated in Washington, D.C. and the university world about banking, securities, and public finance. By comparison, the insurance industries are nearly *terra incognita* in Washington, and the banking and securities regulators (Federal Reserve, OCC, FDIC, FHLBB, and SEC) are badly prepared to police and supervise problems in the insurance field. More extensive studies are desirable before any drastic commingling of banking or securities into insurance is allowed.

freedom for mergers is allowed before careful supervision and accountability develops at the federal level.

Of growing concern lately are problems with pension fund reserves, with increased risk factors for these institutions.<sup>84</sup> Although the Employee Retirement Income Security Act of 1974 (ERISA) mandates substantial, long-term improvement in funding for pension plans, serious difficulties developed recently. In declining industries, like steel and other troubled sectors, claims are mounting against the Pension Benefit Guarantee Corporation (PBGC), especially for defined benefit plans. More recently, major declines in U.S. stock prices during the fall of 1987 placed greater strain on some of these and other pension plan reserves. Unfortunately, Congress must soon cope with these problem areas in the American financial system. More extensive studies, data collection, and most likely, further reforms will be needed. Stronger supervision and accountability would be desirable, along with earlier warning and corrective remedies for depletion and problems with reserves in pension plans and funding. In any event, however, we should be careful not to aggravate risks or encourage looseness. It would be unwise to weaken the framework for oversight of pension reserves and funding whether trusted by insurance companies, banks, employers, or union officials. These are additional reasons for proceeding with caution, ample study, and care not to disrupt existing pension and insurance funding and reserves.

#### IV. CONCLUSIONS

Strong banking and financial institutions reflect their economy. If a country's industry, agriculture, productivity, and growth are solid, its financial institutions also tend to be prosperous. This implies healthy engagement with the world economy, expanding exports, reasonably balanced trade, and no significant distortions.<sup>85</sup> Undue speculation, serious mismanagement, or irresponsible governmental or banking finance can cause losses and disruption to the economy. Inflation, recession, or even depression may follow. In this way, sound fiscal and financial policies and the general well-being of the economy are interrelated and reinforce each other. Yet weakness, failure, and misfortune often spread unless they are carefully minimized or otherwise corrected in a timely and responsible manner.

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84. See, e.g., Cahan, *The Shrinking Nest Egg: Retirement May Never Be the Same*, BUS. WEEK, Dec. 8, 1986, at 114; Cahan & Weiss, *The Huge Pension Overflow Could Make Waves in Washington*, BUS. WEEK, Aug. 12, 1985, at 71; Ehrlich, *AMF's Agony Over Tapping the Pension Till*, BUS. WEEK, Jan. 21, 1985, at 97; Ehrlich, Cahan & Levine, *Putting the Traditional Pension Out to Pasture*, BUS. WEEK, May 5, 1986, at 102; Geisel, *PBGC Setting Precedent in Returning Plans to LTV*, BUS. INS., Sept. 28, 1987, at 1; Jereski, *Some Choice!*, FORBES, May 4, 1987, at 58; Jereski, *The Surplus Vanishes*, FORBES, Nov. 17, 1986, at 94; Koselka, *Mystery Money*, FORBES, Aug. 11, 1986, at 74; Myers, *Directed Brokerage and "Soft Dollars" Under ERISA: New Concerns for Plan Fiduciaries*, 42 BUS. LAW. 553 (1987); Roberts, *Treasury's Assault on Middle Class Pensions*, BUS. WEEK, Nov. 18, 1985, at 26; Tasini, *Playing With Pension Funds: What's the Limit?*, BUS. WEEK, Nov. 17, 1986, at 89; Weiss, *Fat Pension Funds Can Make Companies Tempting Targets*, BUS. WEEK, Nov. 10, 1986, at 106; Karr, *Senate Panel Votes Bill That Doubles Concerns' Pension-Insurance Premiums*, WALL ST. J., Oct. 12, 1987, at 4, col. 2; *Get Serious About Protecting Pensions*, N.Y. TIMES, June 1, 1987, at 16, col. 1 (editorial).

85. See *Reform Hearings*, *supra* note 13, at 42-45 (part 3) (testimony of William A. Lovett); see also J. FAUX, *supra* note 31, at 1; W. LOVETT, *BANKING*, *supra* note 1, at 79-109, 422-34; W. LOVETT, *TRADE*, *supra* note 29, at 5-15, 189-225.

Financial strains of the 1980s for U.S. multinational banks with LDC debt overloads, agricultural banks, oil-patch banking, and over-speculative thrift institutions, especially those in energy slump areas, were the most serious difficulties for depository institutions since the Great Depression and the 1930s. These problems forced a re-evaluation of New Deal era reforms—government deposit insurance such as FDIC, FSLIC, the recent NCUSIF, and the more limited SIPC (Securities Investor Protection Corporation), and PBGC (Pension Benefit Guaranty Corporation), together with our gradually strengthened regime of prudential regulation and supervision.<sup>86</sup> The problem of moral hazard, however, has received more attention in recent years since some insured institutions lack sufficient market discipline against imprudent lending, speculative excess, and mismanagement.

A consensus seems to be emerging for a better balanced, improved regime of banking supervision, prudential safeguards, deposit-insurance protection, and risk-based capital requirements. While global competition for deposits among banks enforces 100% de facto depositor protection, bank stock shareholders, and the holders of preferred stock debentures and other securities bearing capital risk, must shoulder the primary burden for loss due to mismanagement of their institutions. But bank officers and directors suffer major risks of legal liability arising out of failed institutions that cause significant losses to shareholders, because they are likely to be sued for breach of fiduciary duty or mismanagement. Where banks or financial institutions suffer from "systemic" breakdowns, or from serious weakness in their regional or national economic fortunes, however, federal bank regulators and

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86. See G. BENSTON, *supra* note 1, at 303–25; W. LOVETT, *BANKING*, *supra* note 1, at 422–56; I. SPRAGUE, *supra* note 1, at 232–64; see also *Reform Hearings*, *supra* note 13; *Fraud Hearings*, *supra* note 81; R. BRUMBAUGH, *supra* note 10, at 113–80; M. CLARKE, *supra* note 81, at 161–75; J. GRADY & M. WEALE, *supra* note 46, at 175–92; C. HENNING, *supra* note 1, at 90–98; E. KANE, *supra* note 10; D. KIDWELL & R. PETERSON, *supra* note 1, at 410–18; N. LASH, *supra* note 1, at 102–25; R. LITAN, *supra* note 14, at 144–89; M. MALLOY, *supra* note 13, at § 7; T. MAYER, *supra* note 1, at 29–38; M. MORAN, *supra* note 81, at 144–62; Baer, *supra* note 10, at 56; Baer & Brewer, *supra* note 10, at 28; Bardos, *supra* note 11, at 26; *Basle Committee*, *supra* note 11, at 135; *Basle Risk-Based Capital Standards*, *supra* note 11, at 143; Bock, Beaty & Woodbury, *supra* note 81, at 30; Bock, Hornik & Svoboda, *supra* note 8, at 60; Cabos & Snyder, *Optional Excess Deposit Insurance*, in *DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT VII-1* (Federal Deposit Insurance Corporation ed. 1983); Cahan, *supra* note 84, at 114; Cahan & Weiss, *supra* note 84, at 71; Caliguire & Thomson, *supra* note 8, at 1; *Central Bankers*, *supra* note 11, at 101; *Congress Should Concentrate*, *supra* note 10, at 266; *Congress Will Provide*, *supra* note 8, at 307; Cranford, *supra* note 14, at 2096; *Dingell Promises*, *supra* note 14, at 251; *Direction of the Financial Services Industry*, *supra* note 13, at 965; Ehrlich, *supra* note 84, at 97; Ehrlich, Cahan & Levine, *supra* note 84, at 102; *FDIC Has Become*, *supra* note 8, at 252; *Fed Adopts Risk-Based*, *supra* note 11, at 201; *Fed May Let*, *supra* note 11, at 79; *Fed Staff Summary*, *supra* note 11, at 232; *Financial Restructuring*, *supra* note 13, at 4; Geisel, *supra* note 84, at 1; Gilbert, Silverberg & Watson, *Adequacy of the Insurance Fund and Revisions to Assessment Procedures*, in *DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT V-1* (Federal Deposit Insurance Corporation ed. 1983); Gorman, Hornik & Woodbury, *supra* note 8, at 54; Greenwald & Ungeheuer, *supra* note 81, at 42; *Insuring Confidence—Deposit Insurance Reform*, *supra* note 10, at 111; Isaac, *supra* note 10, at 195; Jereski, *Some Choice!*, *supra* note 84, at 58; Jereski, *The Surplus Vanishes*, *supra* note 84, at 94; Kane, *Confronting Incentive Problems in U.S. Deposit Insurance: The Range of Alternative Solutions*, in *DEREGULATING FINANCIAL SERVICES 97* (G. Kaufman & R. Kormendi eds. 1986); Kareken, *supra* note 10, at 1; Kaufman, *supra* note 10, at 25; Keeley, *supra* note 10, at 1; Keeton, *supra* note 10, at 28; Koselka, *supra* note 84, at 74; Litan, *supra* note 14, at 41; Malloy, *supra* note 11, at 75; Myers, *supra* note 84, at 26; *National Council*, *supra* note 10, at 409; Nussbaum, *supra* note 81, at 74; *Ongoing Divisions*, *supra* note 14, at 257; Roberts, *supra* note 84, at 26; Sciacca, *Merger of the Deposit Insurance Funds*, in *DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT VI-1* (Federal Deposit Insurance Corporation ed. 1983); Scott & Mayer, *supra* note 10, at 857; *Senate Adopts Resolution*, *supra* note 8, at 204; Tasini, *supra* note 84, at 89; Weiss, *supra* note 84, at 106; Comment, *supra* note 10, at 594; Nash, *supra* note 47, at 1, col. 1; Brumbaugh & Litan, *supra* note 8, § 3, at 3, col. 1; Karr, *supra* note 84, at 4, col. 2; Sprague, *supra* note 14, at 28, col. 3; Nash, *supra* note 81, at 1, col. 1; *Get Serious About Protecting Pensions*, *supra* note 84, at 16, col. 1.

Congress can be relatively generous with lender-of-last-resort support, and even recapitalization credits, if necessary. Recent experience clearly demonstrates that continued and strong bank supervision is essential and that institutions should be closed or forced into mergers *before* their losses exceed capital and reserves. Letting insolvent institutions flounder along, desperately seeking to restore themselves with risky end-game plays usually leads to even larger burdens and losses for government deposit insurance funds, like those experienced by the FSLIC and FDIC in recent years.<sup>87</sup>

Improved market discipline for banks and thrifts is being strengthened through the new Basle G-12 risk-based capital requirements. These arrangements enhance capital adequacy in a fair way, but with reasonable flexibility to reflect more modest risks for stronger assets.<sup>88</sup> Risk-oriented deposit insurance premiums may supplement risk-based capital requirements within a modest range of fifty, one hundred, or even two hundred percent of normal premiums. But inherent problems in developing specific knowledge about an institution's particular situation, along with disclosure problems, make it impractical to rely exclusively, or even primarily, upon risk weighted deposit-insurance as a safeguard against mismanagement or undue risk-taking by bank leadership.<sup>89</sup> It is also vital to charge all depositors—*foreign as well as domestic*—with the expense of deposit insurance since modern U.S. bank regulators give effective 100% de facto deposit protection for all international and domestic deposits. In no way can a "free ride" or illegitimate subsidy be justified for international bank operations.

One complication needs more careful attention. This is the problem of differential and lower capital requirements (or risk weights) for securities affiliates compared to banks and bank holding companies. Under existing U.S. law, the largest securities firms that do most of the securities underwriting are allowed a very low capital requirement of only two percent of aggregate debit balances with customers. The normal Basle G-12 capital requirement for banking institutions will be eight percent after 1992, except for "low" risk assets. If U.S. banks or thrifts are allowed to form securities affiliates, as many propose today, it is necessary that strong firewalls be established to insulate these activities effectively from each other. There is a real and substantial danger that bank holding companies with securities affiliates could divert much of their corporate bank lending into securitized underwriting activities through their securities affiliates and thus evade and emasculate much of the intended benefit from the new Basle G-12 "level playing field" and uniform risk-based capital requirements for banking institutions. To the extent additional securities activities are allowed for banks and bank holding companies, it is important to enforce the new capital requirements fairly for all sizes and classes of banking institutions, including major multinationals, regional banks, independent and community banks, together with savings banks and S & Ls.<sup>90</sup>

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87. See *supra* notes 33–56 and accompanying text; see also Bartlett, *Are Bailouts the Answer*, N.Y. Times, Sept. 14, 1988, at 1, col. 1.

88. See *supra* notes 57–71 and accompanying text.

89. See *supra* notes 10–12, 45–60 and accompanying text.

90. See *supra* notes 57–60, 72–84 and accompanying text.

APPENDIX TABLE I

Loan Losses for Top 15 U.S. Banks  
(in thousands)

	1982	1983	1984	1985	1986	1987	Total Losses 1982-1987
Citicorp	473,000	530,000	619,000	1,243,000	1,825,000	4,410,000	9,100,000
Chase	263,000	285,000	365,000	435,000	595,000	2,150,000	4,093,000
Bank of America			860,802	2,179,875	2,004,000	1,751,000	6,995,677
Chemical	117,143	166,340	165,220	281,374	439,308	1,492,000	2,661,385
JP Morgan	114,000		150,000	335,000	265,000	960,000	1,824,000
Man. Han.	158,647	227,513	394,824	622,831	858,948	2,236,714	4,499,477
Sec. Pacific	162,411	155,899	387,679	379,400	502,900	1,066,300	2,654,589
Bank's Trust	114,000	80,000	230,000	175,000	306,000	862,000	1,767,000
1st Interstate	182,600	216,200	228,800	375,600	475,100	1,254,100	2,732,400
Wells Fargo	115,417	121,109	194,593	371,836	361,700	892,000	2,056,655
1st Chicago	112,500	150,000	464,800	411,200	440,000	1,305,000	2,883,500
Cont. Ill.			1,226,400	118,000	105,000	823,900	2,273,300
Mellon Bank	68,085	52,199	116,676	148,321	315,585	1,056,000	1,756,866
Bank of Boston	48,000		180,000	115,000	195,000		538,000
1st Bank System	168,900	89,000	135,400	179,700	507,000	260,400	1,340,400
	\$2,097,703	\$2,073,260	\$5,719,194	\$7,371,137	\$9,195,541	\$20,519,414	\$47,176,249

Sources: Based on annual and quarterly reports by Chief Financial Officers of cited banks. Table was compiled by author using such reports.

APPENDIX TABLE II

Capitalization—Top 12 U.S. Banks  
(in thousands)

	1982		1982		1987		1987	
	Assets	C/S Equity (%)	Shareholder's Equity	Primary Capital (%)	Assets	C/S Equity (%)	Shareholder's Equity	Primary Capital (%)
Citicorp	129,997,000	(3.7) 4,815,000	4,815,000	(3.7) 4,855,000	203,607,000	(3.5) 7,220,000	8,810,000	(6.6) 13,468,000
Chase	80,862,903	(2.8) 2,236,413	2,761,413	(4.1) 3,319,690	99,133,396	(3.3) 3,250,286	3,913,611	(6.7) 6,632,763
Bank of America	119,004,069	(3.6) 4,278,898	4,278,898	(4.1) 4,909,368	92,833,000	(2.7) 2,472,000	3,259,000	(7.0) 6,522,000
Chemical	48,167,279	(3.3) 1,586,004	1,944,635	(4.7) 2,262,938	78,189,000	(2.9) 2,299,000	3,003,000	(6.5) 5,071,000
JP Morgan	58,597,000	(4.6) 2,710,000	2,710,000	(5.2) 3,056,000	75,414,000	(6.3) 4,786,000	5,036,000	(8.9) 6,744,000
Man. Han.	64,040,552	(3.2) 2,073,518	2,473,518	(4.6) 2,944,320	73,348,117	(2.8) 2,060,648	2,704,148	(7.3) 5,356,699
Sec. Pacific.	34,741,000	(4.0) 1,391,000	1,391,000	(4.7) 1,627,000	72,838,000	(4.2) 3,063,000	3,363,000	(6.9) 5,051,000
Bank's Trust	40,427,059	(3.5) 1,405,750	1,555,750	(4.4) 1,787,493	56,520,593	(5.1) 2,889,000	2,889,090	(7.4) 4,187,197
1st Interstate	40,884,000	(4.2) 1,700,000	1,789,000	(5.1) 2,074,000	50,926,582	(3.9) 2,013,292	2,165,745	(6.6) 3,386,231
Wells Fargo	24,814,047	(4.4) 1,100,435	1,100,435	(5.2) 1,290,973	44,183,300	(4.2) 1,842,600	2,247,600	(8.2) 3,604,800
1st Chicago	35,876,372	(3.8) 1,366,333	1,481,333	(4.7) 1,684,480	44,209,268	(3.1) 1,369,228	1,801,801	(7.6) 3,349,035
Cont. Ill.	42,899,424	(4.0) 1,709,895	1,709,895	(4.9) 2,089,978	32,391,000	(1.5) 470,000	1,364,000	(7.7) 2,491,000
Total-Top 12 Banks	\$720,310,705	\$26,373,246	\$28,010,868	\$31,901,240	\$923,593,256	\$33,735,054	\$40,556,995	\$65,863,725
Weighted Average %		3.66%	3.88%	4.42%		3.27%	4.00%	6.81%
Total Assets end year								
All U.S. Commercial Banks	\$1,918,200,000				\$2,730,400,000			

Sources: Based upon annual and quarterly reports by Chief Financial Officers of cited banks. Table was compiled by author using such reports.

